Chapter VI

Cost Allocation

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Introduction

SBC Communications, Inc. (SBC), Ameritech Corporation (Ameritech), and Ameritech Illinois (AI) are required to follow Federal Communications Commission (FCC) regulations pertaining to affiliate transactions and the separation of costs of their regulated telephone service from the costs of their non-regulated business activities. The cost allocation standards and affiliate transaction rules are published as Part 64 of Title 47 of the Code of Federal Regulations (CFR) and other FCC pronouncements. The purpose of these rules is to ensure that the companies' regulated services do not subsidize non-regulated activities.

The rules regarding cost allocation are contained in 47 CFR Section 64.901, *Allocation of Costs*. These rules describe the methods to be used to separate non-regulated activities from the regulated Part 32, Uniform System of Accounts (USOA). The rules call for the first option for allocation to be direct assignment of costs to regulated services and non-regulated activities wherever possible. Indirect assignment is the second option for allocation, linking the indirect method to other direct assignments where possible. Finally, a general allocator can be used for costs that cannot be assigned either through direct or indirect means. In accordance with Part 64, the general allocator assigns costs to regulated and non-regulated accounts based upon the results of and in the same proportion as the direct and indirect cost assignments.

Ameritech executes its cost allocation process in the Part 64 Cost Allocation System (PCAS) and reports the allocated costs to the FCC in its annual ARMIS Joint Cost Report 43-03. The Company also prepares ARMIS 43-03 type reports monthly for internal analysis. Further discussion of PCAS is provided later in this chapter of the report.

In accordance with FCC regulations, Ameritech is required to file a Cost Allocation Manual (CAM) that describes how the affiliate transactions rules and cost allocation standards are applied. The CAM describes the nature and frequency of transactions among affiliated companies and how costs are either directly assigned or allocated between regulated and non-regulated activities.

The Company is also required to comply with FCC reporting and independent audit requirements. AI is subject to similar regulations adopted by the Illinois Commerce Commission (ICC or Commission). In addition, in their orders approving the SBC/Ameritech merger, both the FCC and ICC adopted specific requirements relating to affiliate transactions and reporting.

FCC Cost Allocation Guidelines

FCC Docket 86-111, *Separation of Costs of Regulated Service from Costs of Non-regulated Activities*, addresses telephone company cost allocation methodologies and filing requirements. The Report and Order in this docket was issued February 6, 1987, and requires that telephone companies follow the fully attributed cost methodology in determining the apportionment of costs between regulated and non-regulated operations. The fully attributed cost methodology requires that a company's total costs be allocated to either regulated or non-regulated activities. The Order also requires that companies file a Cost Allocation Manual with the FCC documenting the methodologies used to accomplish the fully attributed cost apportionment.

47 CFR Part 64, Section 64.901 to 64.904 (Part 64) codifies the requirements established in Docket No. 86-111. Part 64 cost allocation provisions are summarized in Exhibit CA-1.

Exhibit CA-1
Part 64 Cost Allocation Provisions

Section	Title	Provisions
64.901	Allocation of Costs	• Contains the requirement for the use of fully attributed cost methodology of cost allocation. • Establishes the principles for allocation: tariff; direct; indirect; general allocator, homogeneous cost categories (cost pools). • Prohibits use of "services that are not competitive to subsidize services subject to competition."
64.902	Transactions with Affiliates	• Provides linkage to Section 32.27, which contains the accounting rules for transactions with affiliates.
64.903	Cost Allocation Manuals	• Contains the requirement for filing of cost allocation manuals and describes the type of information to be included in the manual: (1) description of regulated activities; (2) description of incidental activities; (3) chart of affiliates; (4) identification of affiliate transactions; (5) cost allocation procedures; (6) description of time reporting procedures and methods. • Annual update and other interim filing requirements. • Commission authority to require the filing of manuals.
64.904	Independent Audits	• Establishes requirements for annual audit.

Source: 47CFR Part 64, Sections 64.901 to 64.904

The FCC cost allocation guidelines and filing requirements have been further refined over the years as detailed in Exhibit CA-2.

Exhibit CA-2
FCC Cost Allocation Guidelines and Requirements

Docket or Document	Date	Description
Docket No. 86-111	February 6, 1987	Established requirement for fully attributed cost methodology and the filing of a CAM.
Responsible Accounting Officer (RAO) Letter 19	December 23, 1991	Established the uniform format of the CAM and the standard procedure for filing revisions.[i]
FCC Docket No. 96-150	December 24, 1996	Order modifies the affiliate transactions rules to provide greater protection against subsidization of competitive activities by subscribers to regulated telecommunications services. These amendments include: (1) establishing uniform valuation methodologies for the provision of services and the transfer of assets between regulated and non-regulated affiliates; (2) establishing an exception to the valuation rules for non-regulated service affiliates providing services to a regulated affiliate; (3) allowing prices appearing in certain publicly-filed agreements in the place of tariff rates when tariff rates are not available; and (4) applying the authorized rate of return on interstate services, currently 11.25%, when determining fully distributed cost. [ii]
RAO Letter 26	May 6, 1998	This letter revises the guidelines carriers must follow in preparing the Affiliate Transactions section of their CAM

Source: BWG Analysis; FCC website.

The Ameritech Cost Allocation Manual

In accordance with RAO Letter 19, the Ameritech CAM (ACAM) consists of seven sections as outlined in Exhibit CA-3. Further discussion of specific sections is provided below. ACAM provisions relating to Transactions with Affiliates are discussed in the Affiliate Transactions chapter of the report.

[i] RAO Letter 26 modified portions of this RAO Letter.

[ii] This Order is commonly referred to as "The Accounting Safeguards Order". It contains the accounting safeguards to satisfy the requirements addressed in Sections 260 and 271 through 276 of the Communications Act of 1934, as amended by the Telecommunications Act of 1996.

Exhibit CA-3
Overview of the Ameritech Cost Allocation Manual

Section	Description
I. Introduction	Provides a general overview of the purpose of the ACAM and a description of the remaining sections.
II. Non-regulated Activities	Provides a description of the non-regulated activities and services engaged in by the Company. Non-regulated activities are those that are either pre-emptively detariffed (e.g. Inside Wire) or never before subject to regulation (e.g. Voice Messaging).
III. Incidental Activities	Describes incidental activities performed by the Company. Incidental activities are an outgrowth of regulated operations and cannot constitute a separate line of business.
IV. Chart of Affiliates	Displays the current organization charts of the SBC/Ameritech corporate family.
V. Transactions With Affiliates	Identifies each non-regulated affiliate with which the Company engages in, or potentially will engage in, transactions. Describes the terms, frequency and nature of each transaction.
VI. Cost Apportionment Tables	Defines the methodology used to apportion costs between regulated services and non-regulated activities.
VII. Time Reporting Procedures	Describes the methods of distribution used by Ameritech to apportion wages and salaries of employees engaged in regulated services and non-regulated activities. These methods are positive time reporting and exception time reporting.

Source: Ameritech Part 64 Cost Allocation Manual (Document Request IDR 1.1)

Non-Regulated Activities

Exhibit CA-4 is a listing of services offered by Ameritech that are treated as non-regulated for accounting purposes.

Exhibit CA-4
Ameritech Non-Regulated Activities and Services

Non-Regulated Activity or Service	Description
Customer Dialed Account Recording (CDAR)	Enables the customer to add account numbers to the Automatic Message Recording (AMA) record of any call that is subsequently detailed on the customer's bill.
Debit Card	Includes the production and distribution of plastic cards which may have an encoded magnetic strip, and may be imprinted with unique account codes. These cards will be issued in various denominations, and will always include Ameritech's corporate logo. This activity will include debit card promotion.
Digital NCTE	NCTE is generally associated with the provision of 1.544 Mbps Private Line Service. The equipment performs functions such as signal regeneration and circuit termination.
Enhanced 911 Services (E911)	E911 carries calls to public service answering points (PSAPs) where the calls are then forwarded to emergency services (e.g., fire, ambulance, police, etc.). Unlike basic 911 services where only a call is transmitted, E911 services provide a PSAP with additional information about the calling party.
Enhanced (Facsimile) Fax Service	Provides for the automated delivery of fax information. Features of this service include the storage of incoming fax information for future retrieval, allowing a customer to retrieve information from any fax machine and the automatic retry of calls to a fax machine that previously was busy. Additionally, this service allows the customer to send one document to multiple locations simultaneously, and will provide usage statistics by internal department or external customer.
Enhanced Services Planning	The planning and development of enhanced services that are not uniquely identifiable with a particular product or service. This activity encompasses the phases in a product's life cycle which are associated with the evaluation of potential enhanced services and development plans to make them operational.
Incidental InterLATA Services	Consists of certain incidental interLATA services such as incidental interLATA signaling that Ameritech was authorized to provide.
Inmate Services	Consists of pay telephone sets that are installed within a correctional institution's premises. A separate platform can monitor, time and block calls that inmates make.
Inside Wire	Materials and labor installed on the customer's side of the demarcation point. Optional maintenance agreements that provide for the repair of inside wire, the determination of whether a service difficulty is the result of customer equipment or telephone company facilities, and under some agreements, the loan of a telephone set as a temporary replacement. Inside wire services also include the repair and maintenance of complex premises wiring which is performed on an individual customer basis.
Joint Marketing of Services	Joint marketing of enhanced and other services provided by third party vendors as well as affiliated companies.

Exhibit CA-4
Ameritech Non-Regulated Activities and Services

Non-Regulated Activity or Service	Description
Message Delivery Service (MDS)	Provides customers a means of recording a message and having delivery attempts made to a called party when a busy or no answer condition exists. Enhanced features for this service may include deferred delivery, monitoring the status of the message delivery, remote access, modification of the message and the delivery date and time, interaction with prerecorded information among other features.
National Directory Assistance Service (NDA)	This service provides customers the ability to obtain non-local telephone listings for anywhere in the United States.
Payphone Equipment	Payphone equipment has been reclassified to non-regulated status pursuant to the FCC's Order in CC Docket No. 96-128 released September 20, 1996. To the extent that this equipment will use the tariffed offerings of Ameritech Illinois, these services will be charged to the non-regulated activity at the tariffed rate.
Personal Access Services (PAS)	PAS allow stored fax information, voice mail and screening capability (e.g., PIN, recorded name and spoken caller number) transmission to an end user in accordance with an end user programmed call treatment hierarchy.
Professional Services	An array of professional (e.g., legal, tax, marketing, human resources, etc.) services provided by third party vendors as well as those developed internally.
Protocol Conversion	An enhanced service adjunct to three different classes of underlying basic services: 1) exchange telephone services; 2) private line service; and 3) the Ameritech Packet Switched Network (APSN). Protocol conversion includes conversion of a customer's protocol to a network compatible protocol or any other desired protocol.
Responsible Organization Services (Resporg)	Allow third parties access to a central 800 services management system (SMS/800) database. Elements of Ameritech Illinois' Resporg services include 800 number administration and Resporg ID services.
Reverse Search Service	Allows direct customer access to a database containing directory assistance data via a modem and personal computer. Will allow customers to search the database of telephone subscribers' names, addresses, and telephone numbers by telephone number rather than name only.
Sales, Installation and Maintenance of Customer Premises Equipment (CPE)	Ameritech Information Systems, Inc., a wholly-owned subsidiary of Ameritech Corporation, markets, installs and maintains CPE.
Software Sales	Sale of software either purchased for resale or internally developed to nonaffiliated third parties.
Spread Spectrum Alarm Service	Transmission of alarm information between an alarm company and its customers.
Voice Messaging Services (VMS)	Provides residential or business customers with the ability to record a personal greeting when the subscriber is unavailable to answer the phone in person. Messages are stored in a digital format for future retrieval. The subscriber may store, review, redirect, broadcast, scan and delete messages.

Source: Ameritech Part 64 Cost Allocation Manual (Document Request IDR 1.1)

Incidental Activities

Incidental activities are an outgrowth of regulated operations. Under FCC rules, Incidental Activities cannot constitute a separate line of business, and the sum of the revenues from such activities cannot exceed one percent of total revenues in a given a year. Ameritech's Incidental Activities are shown in Exhibit CA-5.

Exhibit CA-5
Ameritech Incidental Activities

Functional Group	Incidental Activity
Facilities, Maintenance and Operations	• Sales of Cable Plats and Other Job Prints • Building Alteration Work for Tenants • Provision of Cable TV Services to Operators, such as performing surveys, studies and inspection work and installing cable extension brackets • Selected Custom Work such as Non-tariffed Outside Plant Rearrangements and Maintenance • Television Facilities Rental • Land and Building Space Rental • Pole Contact and Conduit Space Rental (tariffed) • Other Outside Plant Rental (tariffed) • Central Office Equipment Rental • Cable Locating • Alarm Service Monitoring for Independent Telephone Companies • Trunk Transmission Testing and Cable Maintenance • Vendor Installation and Maintenance Coordination
Financial and Administrative	• Special Billing Arrangements for Billing Detail in Other than Printed Form, such as the provision of billing detail to subscribers in the form of reproductions of punched cards or magnetic tapes (tariffed) • Account Maintenance Services for Nonaffiliates for Whom AI does not Provide Billing Services • Communications Revenue Protection • Training Courses Offered on an Open Seat Basis • Commercial Credit Card Processing • Printing, Enclosing and Distribution of Materials for Third Parties
Customer Information Services	• List Rental • Street Address Directories • Validation Data Base Information
Marketing	• Booth Advertising • Media Design • Other Advertising such as Bill Inserts • Paid Advertising in Company Newspapers/Magazines • Direct Marketing Center Activities for Third Parties
Miscellaneous	• Operator Services not Covered by Tariff • Miscellaneous Provision of Documents • Trade Show Space Rental • Royalties from Inventions Associated with Regulated Operations • Sale and Maintenance of Software Developed for Regulated Operations • Coin Counting and Wrapping • Revenue from Employee Group Activities

Source: Ameritech Part 64 Cost Allocation Manual (Document Request IDR 1.1)

Cost Apportionment Methodologies

Ameritech uses a specific cost apportionment methodology to distribute USOA Part 32 costs to its regulated services and non-regulated activities. The ACAM includes the following information for each applicable USOA Part 32 account:

- Cost Pool Title
- Cost Pool Apportionment Basis
- Regulated/Non-regulated Apportionment Basis
- Cost Definition: Direct or Indirect Basis of Allocation.

Cost Pools

Cost pools represent a homogeneous group of costs and reflect the USOA Part 32 account structure, further subdivided as necessary to permit analysis based on cost causation.

Whenever possible, cost pools are established using accounts, sub-accounts, field reporting codes and accounting codes to provide for the direct assignment of labor, material, voucher and other expenses to regulated services or non-regulated activities. Some cost pools are established based upon an analysis of accounting records and supporting documentation or by an investment-based apportionment to permit direct assignment of the costs to regulated services and non-regulated activities.[i] Further apportionment is permitted only when a cost pool cannot be directly assigned.

Cost Definition

Costs apportioned to regulated services and non-regulated activities are in four major categories:

- **Directly Assignable**: costs incurred exclusively for either regulated services or non-regulated activities.
- **Directly Attributable**: costs which are incurred for both regulated services and non-regulated activities which can be apportioned using direct measures of causation.
- **Indirectly Attributable**: costs which are incurred for both regulated services and non-regulated activities which are apportioned using indirect measures of causation.
- **Unattributable**: costs which are shared by both regulated services and non-regulated activities for which no direct or indirect causal relationship exist.

[i] Examples of these types of analyses would be: Analysis of Motor Vehicle Records; Analysis of Rented Land and Buildings; and a Building Use Study.

Time Distribution

Ameritech uses two basic methods to apportion wages and salaries of employees engaged in regulated services and non-regulated activities: positive time reporting and exception time reporting.

- **Positive Time Reporting**: used by those employees who can segment a day into distinct tasks or functions.
- **Exception Time Reporting:** used by employees who predominantly perform certain work functions but who occasionally perform identifiable duties outside of their normal assignment.

Positive Time Reporting

Employees subject to positive time reporting are able to segment their day into increments of time. These employees have two methods for time reporting: 1) the enhanced time distribution process, which is a statistical sampling system, and 2) conventional positive time reporting.

Enhanced Time Distribution Process

Under the Enhanced Time Distribution Process (ETDP), all hours worked are assigned to a profile which represents a group of employees who perform the same work functions in generally the same geographical location. The ETDP will use a statistically valid sample of these employees to report time on a daily basis. Each sampled employee completes a detailed activity log. The accounting information gathered from these logs is compiled over a three-month period of time and averaged. Factors resulting from the three month rolling average are applied to all hours reported by individuals within the profile to compute current month financial activity including non-regulated activities.

Each employee is responsible for accurately reporting time in accordance with Company procedures. Annually, employees attest to this responsibility by signing an Acknowledgement Form stating that they have reviewed the Code of Business Conduct that explains the employees' responsibilities and the penalty for violations. Instructions and training for ETDP reporting employees emphasizes the importance of reporting time properly to ensure that time spent on non-regulated activities is accurately identified.

Conventional Positive Time Reporting

Conventional positive time reporting is used mainly by the Installation, Maintenance, Repair, Testing, Engineering and Construction forces. Employees who report time on a positive basis do not have a profile of their time for regulated services or non-regulated activities. The method of reporting is a series of Field Reporting Codes (FRCs) or Accounting Codes to identify the specific type of work performed. Typically, employees complete timesheets on a daily basis to record their activities.

The costs of direct supervision and other costs for the support of the field reporting forces are charged to specific reporting codes within the accounting system, and the allocation of support group costs are directly attributable to the positive time reporting groups. Time reporting practices and procedures are subject to ongoing internal audits as well as reviews by independent public accountants.

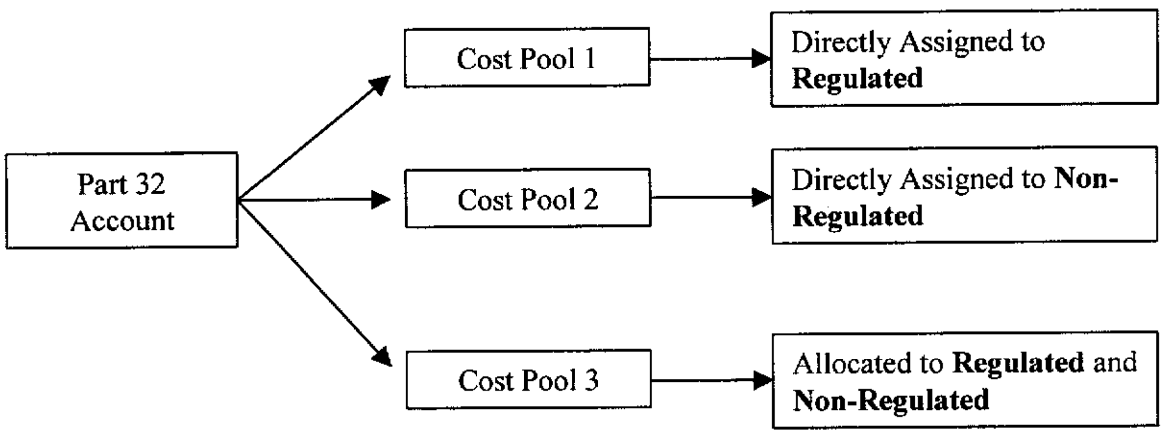
Exception Time Reporting

Exception time reporting is used to report exceptions to an employee's predefined profile. A profile represents the activities in which employees are engaged on a fixed and recurring basis and is used as the basis for accounting for their salaries, wages and other costs. Employees exception time report when they work outside of their normal pre-assigned activities or profile. Work that benefits non-regulated activities must be uniquely coded either as part of the employee's work profile or in the exception time reporting process.

The Ameritech Part 64 Cost Allocation System

The Part 64 Cost Allocation System (PCAS) was created to separate regulated and non-regulated costs and to pass them to the Separations System for use in preparing FCC ARMIS Joint Cost Report 43-03.[i] An overview of the PCAS process is provided below.

Exhibit CA-6
Overview of PCAS Process



Source: BWG Analysis

Each month a series of procedural steps are executed to perform Part 64 cost allocation. The process begins by apportioning or assigning specific Part 32 Account Balances into homogeneous groupings of similar costs called cost pools. The balances in the cost pools are then allocated between regulated and non-regulated activities.

PCAS uses tables to identify Account/Cost Pool relationships for cost pool apportionment. These tables provide direction to the Ameritech Financial Information Warehouse (AFIW), General Ledger and other detail to identify valid Part 64 records. The four primary PCAS tables that drive the apportionment processes are:

[i] SBC also has a PCAS. Its acronym stands for Parent Cost Allocation System.

- **AFF Table:** lists Part 64 accounts requiring apportionment, related cost pools and the account/cost pool apportionment basis. It controls how each account is apportioned to cost pools.

- **Reg/Nonreg Table:** defines method used to allocate cost pool amounts into Reg/Nonreg categories. It controls how each cost pool is split between regulated and non-regulated amounts.

- **Activity Code Table:** is used to identify dollars for extraction from the AFIW which are passed to the system for processing. In addition, this table is used in the Wage and Salary Ratio Development process to identify dollars used in wage and salary calculations.

- **Wage and Salary Table:** is used to identify transaction category code (TCC) dollars for extraction from the AFIW which are then used in the wage and salary calculations.

Audit Objectives

- Determine the adequacy of procedures and controls governing the Ameritech cost allocation process.

- Determine whether the AI Cost Allocation process, as documented in its CAM, properly allocates costs between regulated and non-regulated activities.

- Determine whether the AI ARMIS Joint Cost Report 43-03 reflects the allocation of costs.

Evaluative Criteria

- Are Ameritech cost allocation procedures and controls adequate to avoid the occurrence of material misstatements?

- Does the AI Cost Allocation process, as documented in its CAM and executed in PCAS, properly allocate costs between regulated and non-regulated activities?

- Has Ameritech adequately considered the need to review allocation methodologies and results following the merger and are these changes reflected in the Company's monthly internal "ARMIS 43-03-type" report?

- Are the allocated costs contained in the internal ARMIS 43-03-type report for the months of January through March 2000 reported correctly?

Summary of Audit Procedures

- Reviewed relevant SBC and Ameritech documents including:

  ⇒ Cost allocation manuals
  ⇒ Cost allocation procedures
  ⇒ PCAS documentation

- Compared the monthly internal ARMIS 43-03-type report information for the 1st Quarter 1999 with the 1st Quarter 2000.

- Compared FCC ARMIS Joint Cost Report 43-03 information for Ameritech and each of its Affiliates.

- Compared FCC ARMIS Joint Cost Report 43-03 information for Ameritech and each of the other RBOCs.

- Compared AIT and AI cost allocation results to other RBOCs and AOCs.

- Validated and tested cost allocation for ten Part 32 accounts.

  ⇒ Tested allocation of Ameritech Part 32 charges to AI
  ⇒ Tested Part 64 cost allocation of AI Part 32 amounts

- Tested PCAS algorithms used to assign expenses to cost pools and to allocate costs to Part 64 categories.

- Interviewed appropriate SBC and Ameritech personnel including the Team Lead for Regulatory Compliance and the Manager of Part 64 Standards.

Findings and Conclusions

1. As discussed in Chapter IV, Internal Controls, Ameritech's cost allocation procedures and controls are adequate to prevent the occurrence of material misstatements. The Company has a well-documented Cost Allocation System and has implemented an appropriate process to ensure compliance with FCC requirements regarding revisions to the ACAM.

   - Ameritech currently has an appropriate, experienced organization in place to control the cost allocation process and ensure ACAM compliance. Ameritech has developed appropriate controls over the cost allocation process.

   - The Company filed the ACAM with the FCC on December 16, 1999. As required by RAO, the Company attached a list of current revisions.

     ⇒ There were 103 revisions to the ACAM in 1999. Many of these revisions are directly related to the merger.

     ⇒ Section V, *Transactions with Affiliates* and Section VI, *Cost Apportionment Methodology* required 49 and 44 changes, respectively.

   - The 1999 internal audit of the 1998 cost allocation process found that the system of internal controls relating to cost allocation was effective.

   - External audits of the 1998 and 1999 ACAMs found the overall control environment to be sound. Specifically, Ernst & Young, LLP in their report to Ameritech Management dated March 28, 2000, found that ARMIS Report 43-03 fairly presented the 1999 allocation of costs. Their audit of the 1999 ACAM consumed approximately 2,800 audit hours. Cost allocation issues disclosed in the audit are summarized in Exhibit CA-7 and were determined not to be material.[i]

Exhibit CA-7
Ernst & Young Audit of 1999 CAM (March 29, 2000)
(Dollars in Thousands)

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2. The results of external audits indicate that the Ameritech cost allocation process, as documented in its CAM and executed in PCAS, properly allocates costs between regulated and non-regulated activities.

   - Both Arthur Andersen and Ernst & Young concluded that the Ameritech PCAS produced ARMIS Reports 43-03 that fairly present the allocation of costs between regulated and non-activities without material misstatements.

[i] A Table containing all findings is included in Exhibit IC-6 in the Chapter IV, Internal Controls.

- (redacted)

- (redacted)

3. The Company's current method of calculating the Marketing Allocator produces an inaccurate result. The Company was made aware of this in the 1999 independent audit and is planning to change its procedures to correct the problem. However, at the time of our audit tests, needed changes had not been implemented.

(Findings Redacted)

4. BWG's testing of transactions during the course of the audit confirms that the PCAS properly allocates costs.

   - BWG validated and tested the cost allocation process in February 2000 for ten Part 32 accounts that were selected based on the dollar value of the account as well as the method used for cost allocation. The accounts selected for testing represented nearly (redacted) percent of the Total Expense of $3.3 billion and more than 65 percent of Total Operating Expense shown in the 1998 ARMIS Report 43-03. The accounts selected for testing are shown in Exhibit CA-8.

   - In addition we tested five expense and one investment accounts associated with the National Directory Assistance Service (NDA). NDA is an extension of the directory assistance service provided by the Local Exchange Companies since divestiture on

January 1, 1984. In 2000, Ameritech began providing its customers the ability to receive telephone numbers for anywhere in the United States. This extended service is performed on a non-regulated basis. BWG selected NDA to test PCAS because this is a new non-regulated service and the associated Part 32 accounts should show initial or increased cost allocation to the non-regulated lines of business.

Exhibit CA-8
Part 32 Accounts Selected for Testing in PCAS
(Dollars in Thousands)

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Part 32 Account	Title	1st Quarter 2000 Amount
6121	Land and Buildings	(redacted)
6124	General Purpose Computers	(redacted)
6212	Digital Electronic Switching	(redacted)
6423	Buried Cable	(redacted)
6533	Testing	(redacted)
6534	Plant Operations Administration	(redacted)
6561	Depreciation-TPIS	(redacted)
6612	Sales	(redacted)
6623	Customer Services	(redacted)
6728	Other General and Administrative	(redacted)
National Directory Assistance Service		
2220	Operator Systems Investment	(redacted)
6220	Operator Systems Expense	(redacted)
6611	Product Management	(redacted)
6613	Product Advertising	(redacted)
6622	Number Services	(redacted)

Source: BWG Analysis; ARMIS 43-03 Reports (FCC Website).

- The testing process included the following steps:

⇒ Obtained PCAS reports for February 1999 and February 2000, which show dollars by cost pool for each account and regulated/non-regulated assignment.

⇒ Obtained supporting reports from PCAS of projected or actual regulated and non-regulated usage (for accounts 2220, 6212, 6220, 6222, 6423); wages and salaries (for accounts 6121, 6534, 6728); service order analysis (for accounts 6533, 6623); and trouble report analysis (account 6533); investment account balances from PCAS and the ARMIS 43-03-type report (used for apportioning expenses pertained to accounts 6121, 6124, 6212, and 6561); and, backup reports showing the calculation of the marketing allocator (for accounts 6611, 6612, 6613) and the general allocator (for accounts 6623, 6728).

⇒ Verified that Cost Pools (CP) for each account were consistent with the ACAM.

⇒ Verified that the sum of the CP dollars for each account closed to the Part 32 account found in the ARMIS 43-03-type report for the month being studied.

⇒ Verified that the reports provided or other account balances supported the dollars assigned to each CP.

⇒ Verified that the reports provided or other account balances supported factors used to assign dollars to the regulated and non-regulated categories in accordance with the CAM.

⇒ Validated that dollars in cost pools to be directly assigned to regulated or non-regulated categories in accordance with the ACAM were so assigned correctly and entirely.

⇒ For shared cost pools to be allocated between regulated and non-regulated activities, verified the factor used for the allocation to insure that there was adequate supporting documentation.

⇒ Performed manual calculations to test the programmed algorithms used in PCAS to produce the same cost allocation result.

- The results of these tests show that accounts are being assigned or allocated correctly and in accordance with the ACAM.

- The following observations were made during the testing of the accounts:

⇒ Procedures for assigning dollars to cost pools and then allocating to the regulated and non-regulated categories are logical and consistent with established cost allocation methodologies.

⇒ As more fully discussed in Chapter IV, Internal Control, Ameritech should develop additional reports in the PCAS Part 64 system in order to facilitate testing and verification of results by internal staff and auditors. Testing now requires extensive effort by staff to produce special documents that support the system's results. Standard reports similar to those available from the Separations System should be produced to improve PCAS documentation.

⇒ The allocated costs contained in the Illinois ARMIS 43-03-type reports for January through March 2000 are reported correctly.

⇒ The Separations System was tested for the initial ten accounts listed above. Results were verified by checking programmed calculations. The sources of dollar amounts and factors are cited in the system's standard output reports. Methods conform to Part 36 of the FCC's Rules and Regulations normally referred to as the jurisdictional separations rules.

5. With a few exceptions that are adequately explained, the overall proportion of Ameritech Illinois regulated and non-regulated costs remained the same for the accounts tested between the 1st Quarter of 1999 and the 1st Quarter of 2000 indicating a consistent cost allocation process.

   - Exhibit CA-9 provides a comparison of Illinois results for the 1st Quarters of 1999 and 2000.

Exhibit CA-9
Comparison of First Quarter Regulated vs. Non-regulated Costs
(Dollars in Thousands)
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- Account 6534 shows an increase in the non-regulated allocation. Because of the influence of weather and other factors, the shift in costs in Account 6534 is not considered unusual.

- The increase in the regulated portion of Account 6728 OG&A was caused by expense credits to Pension Expense in both 1999 and 2000 which has resulted in overall negative expenses in both periods.

- The Company explains the increase in the regulated allocation in Account 6612 Sales as being driven by reduced sales efforts for non-regulated services and the transfer of sales staff to support efforts to market regulated services. As noted above, testing of Account 6612 confirmed appropriate allocation methodology in the PCAS.

6. There was an increase in non-regulated costs between the 1st Quarter of 1999 and the 1st Quarter of 2000 for most of the Part 32 accounts tested related to NDA, which properly reflects the cost-allocation impact of the new non-regulated service.

   - As discussed in Finding No. 4, NDA is a non-regulated service that began in 2000 and the associated Part 32 accounts should show initial or increased cost allocation to the non-regulated lines of business.

   - With one exception, there was a percentage increase in the non-regulated amounts in the accounts tested, as shown in Exhibit CA-10.

   - Account 6611, Product Management, showed a decrease in the percentage of non-regulated costs. However, this percentage is impacted by the error in the calculation of the Marketing Allocator that is discussed in Finding No. 3 above.

Exhibit CA-10
NDA Related Accounts
Comparison of First Quarter Charges to Non-regulated Costs
(Dollars in Thousands)

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7. As compared to their peers, AI and Ameritech have high non-regulated to total cost ratios. This indicates a sufficiently aggressive approach to the allocation of costs to non-regulated activities.

   - As shown in Exhibits CA-11 and CA-12 below, both Ameritech and AI allocate a higher percentage of costs to non-regulated activities than do the majority of the other RBOCs.

   - SBC's Southwestern Bell companies (5 states) have lower non-regulated to total ratios than Ameritech and AI.

   - PacBell's non-regulated allocator is higher in 1999. However, PacBell adopted the SBC CAM in 2000 and it is likely that its allocators have been revised. The nature of the change might be instructional for the Commission when actual allocations are available in the AI year 2000 ARMIS Reports 43-03.

Exhibit CA-11
RBOC Operating Expenses
Percent Non-regulated Dollars
(Dollars in Thousands)

RBOC	Total Operating Expenses 1999	Non-Regulated	Percent Non-Regulated
PacBell	$7,789,000	$1,140,000	14.6%
Ameritech	7,829,000	861,000	11.0%
AI	2,625,000	284,000	10.8%
Southwest	8,951,000	903,000	10.1%
Bell South	10,677,000	1,044,000	9.8%
Bell Atlantic	9,065,000	849,000	9.4%
US West	8,155,000	614,000	7.5%
NYNEX	10,102,000	666,000	6.6%

Note: PacBell changed from its own CAM to the SBC CAM effective January 1, 2000

Source: ARMIS 43-03 Reports (FCC Website); BWG Analysis.

Exhibit CA-12
RBOC Expenses for 10 Selected Accounts
Percent Non-regulated Dollars
(Dollars in Thousands)

RBOC	1999 Expenses (Selected Accounts)	Non-Regulated	Percent Non-Regulated
PacBell	$4,729,000	$42,000	11.5%
Ameritech	5,017,000	529,000	10.5%
AI	1,683,000	165,000	9.8%
Bell South	7,340,000	453,000	6.2%
Bell Atlantic	5,592,000	325,000	5.8%
Southwest	5,613,000	312,000	5.6%
US West	5,249,000	288,000	5.5%
NYNEX	5,990,000	314,000	5.2%

Note: PacBell changed from its own CAM to the SBC CAM effective January 1, 2000

Source: ARMIS 43-03 Reports (FCC Website); BWG Analysis.

8. There are significant differences between the SBC CAM and the ACAM. Conversion by AI to the SBC CAM could produce significant shifts in costs from non-regulated to regulated services.

   - For example the ACAM specifies only one cost pool for account 6124, General Purpose Computer Expense. The SBC CAM has seventeen cost pools for this same account.

   - For account 6532 Testing, the ACAM has nineteen cost pools compared to only four in the SBC CAM.

Quantified Results of Investigation

1. There are no exceptions that have not previously been adjusted by the Company.

Recommendations for the Company

1. To improve the accuracy of cost allocations, calculate the Marketing Allocator based upon the latest three months of experience, similar to the General Allocator, and take steps to normalize anomalies in any of the cost pools used in developing the ratio. (Refers to Conclusion No. 3)

2. To improve system documentation and to facilitate testing and verification of results by internal staff and auditors, develop additional reports in the PCAS Part 64 system. Standard reports similar to those available from the Separations System should be produced to improve PCAS documentation. (Refers to Conclusion No. 4)

3. Keep the Commission fully informed of plans to adopt the SBC CAM. Before adopting the SBC CAM, perform an appropriate analysis of the impact of the proposed changes and provide this information to the Commission. Obtaining information regarding the change in regulated and non-regulated cost allocation of PacBell might be of benefit in the analysis. (Refers to Conclusions Nos. 7 and 8)

Policy Issues for the Commission

None

Future Audit Issues

None

Chapter VII

Recorded Cost and Savings

Chapter VII
Reported Costs and Savings

Introduction and Summary

In this audit area we focus on SBC/Ameritech's compliance with the requirements for the determination and reporting of 1999 costs and savings and one-time merger transaction costs. This is a complex, numbers oriented chapter and we have summarized our analysis of many of the issues that are addressed in exhibits contained throughout the report.

A summary of our proposed adjustments to the cost and savings amounts reported by the Company for 1999 is provided in Exhibit RCS-37 on the last page of this chapter. Based upon our analysis, in the 1999 Costs and Savings Report filed with the Commission on April 7, 2000, for the period from the date of the merger through December 31, 1999, we believe that the Company has overstated reported costs by as much as $1.3 million and should have reported net savings attributable to Illinois of $0.1 million, rather than net cost (negative net savings) of $1.2 million.

Savings and Recoverable Costs

The merger of SBC and Ameritech constituted a reorganization of Ameritech Illinois under Section 7-204 of the Illinois Public Utilities Act (PUA) and required approval by the Illinois Commerce Commission. Section 7-204(c) of the Act states:

> The Commission shall not approve a reorganization without ruling on: (i) the allocation of any savings resulting from the proposed reorganization; and (ii) whether the companies should be allowed to recover any costs incurred in accomplishing the proposed reorganization and, if so, the amount of cost eligible for recovery and how the costs will be allocated. 220 ILCS 5/7-204(c).

Despite the Joint Applicants arguments that Section 7-204(c) did not apply to the merger of SBC and Ameritech, in its September 23, 1999 Order approving the merger, the Commission applied Section 7-204(c) as written, and addressed the meaning of costs and savings. The Commission agreed with the Joint Applicants that the term "savings" in Section 7-204(c)(i) refers to an actual reduction in costs or expenses and does not include revenue enhancements. As for the meaning of costs, the Commission agreed with Staff that none of the one-time merger costs that relate to the change in ownership constitute legitimate costs under Section 7-204(c) and that only those costs directly associated with the utility's operations should be considered for recovery.

Under the terms of Section 7-204(c) the Commission is required to determine how the merger savings, if any, should be shared between ratepayers and shareholders. In its Order, the Commission concluded that 50 percent of the net merger savings allocable to AI should be allocated to consumers, but expressed its belief that the savings and costs as well as their reasonableness should be determined when actual data, as opposed to estimates, are available. Despite arguments by the Staff, the Commission found that to the extent that costs are incurred to produce savings and are shown to be both reasonable and directly related, netting is appropriate.

The Order also required Ameritech Illinois to track its share of all actual merger-related savings and all merger-related costs separately for the period beginning on the date the merger is consummated and ending on December 31, 1999 using the Uniform System Of Accounts (USOA). This information is to be submitted as part of Ameritech Illinois' annual Alt. Reg. filing on April 1, 2000 and continue to be provided in Ameritech's annual price cap filings until such time as an updated price cap formula has been developed in Docket 98-0252. In the annual price cap filings, AI is required to flow-through merger savings net of reasonable costs in the manner described above until such time as an updated price cap formula has been developed. [xiv]

Merger Transaction Costs

In its Order approving the merger, the Commission ruled that merger transaction costs cannot be included in merger-related costs in determining net savings and are consequently the responsibility of shareholders. "It is only those costs directly associated with AI's provision of service which qualify under Section 7-204(c). Hence, we agree with Staff's position to allow recovery of only those costs directly associated with the utility's operations."

In its Amended Order, the Commission provided further clarification, defining transaction costs as:

> ...those costs and expenses incurred in connection with the merger transaction [which] shall include but not be limited to fees and expenses of financial advisors and consultants and lawyers; filing fees; proxy costs; the costs of securing regulatory approval of the transaction; employee retention payments; employee change in control payments; employee severance costs; employee relocation costs; the costs of third party auditing or technical assistance necessary to comply with the conditions imposed by the Commission in this order; the administrative costs associated with the Consumer Education and Community Education funds; and the costs of penalties should conditions and benchmarks imposed by the Commission in this Order not be met.

The Amended Order also stated that "merger-related costs shall not include 'transactional costs,'" and indicated that the payments to the Consumer Education Fund (CEF) and Community Technology Fund (CTF) should not be included in merger-related costs:

> With regards to the CEF and CTF, we agree with Staff that it would be inappropriate and discriminatory for ratepayers to bear the costs of these special interest funds. Therefore, we conclude that all costs associated with these funds, including the costs to administer the funds, should not be netted against merger savings or otherwise recovered from ratepayers.

[xiv] The March 15, 2000 original date was modified to December 31, 1999 in the November 15, 1999 Amendatory Order.

Procedural History

On July 24, 1998, SBC and Ameritech filed a Joint Application seeking the ICC's approval, under Section 7-204 of the Illinois Public Utilities Act ("Act") of the reorganization of AI and Ameritech Illinois Metro, Inc. (AIM) resulting from a proposed business combination of SBC and Ameritech. Under Section 7-204(c) of the Act, the Commission shall not approve a reorganization without ruling on whether the companies should be allowed to recover any costs incurred in accomplishing the proposed reorganization and, if so, the amount of cost eligible for recovery and how the costs will be allocated.

Staff witness provided testimony regarding the categories of costs which should not be recovered from ratepayers:

> Merger transaction costs are the one-time costs incurred to legally consummate the merger. These costs include, but are not limited to, banker or brokerage fees, legal fees, accounting fees, and proxy costs. These costs relate to the change in ownership of Ameritech and are not related to the provision of service by Ameritech Illinois. Therefore, these costs should be considered shareholder costs and no portion of them should be borne by Illinois rate payers. In its Order in Docket 93-0252 dealing with Sprint/Centel merger savings, the Commission concluded that merger transaction costs are one-time expenses that relate to the change in ownership of Centel Corporation and not to the operations of a merged entity or the functioning of the telephone operating companies. It is appropriate for these non-operational costs to be treated as "below the line" expenses which are borne by the shareholders rather than the ratepayers. (See Order at page 10). In my opinion, the petitioners should not recover any of the merger transaction costs from ratepayers.
>
> There are other costs associated with the operations of the merged entity that should be recovered from ratepayers. An example of this type of cost is the increased cost associated with increased staffing levels anticipated after the merger.

Staff further testified that the Commission should determine the specific types of costs that may be recovered from ratepayers and should allow recovery of the reasonable costs that are directly associated with utility operations. Staff believed that identification and quantification of these specific costs was required in order for the Commission to determine the reasonableness of costs to be recovered from ratepayers. Staff emphasized the need for actual data to allow the Commission to evaluate the reasonableness of merger costs prior to their recovery through rates.

While the Joint Applicants disagreed with the application of Section 7-204(c) to the SBC-Ameritech merger, a Company witness provided the Joint Applicants' understanding of the nature of the transaction costs referred to:

> Section 7-204(c)(ii) applies to the costs associated with accomplishing the proposed reorganization. In my view, the "costs" referenced in this section are the one-time, up-front costs incurred to combine Ameritech Illinois and SBC into one corporate entity. These would include the expenses associated with services provided by investment bankers; legal expenses relative to activities before the Securities and Exchange Commission, Department of Justice, Federal Communications Commission and state regulatory commissions; costs associated with investor relations; transaction costs associated with creating new corporate entities, including the costs of converting shares post-merger; and so forth.

In its September 23, 1999 Order, the Commission agreed with Staff that with respect to the meaning of "costs" none of the one-time merger costs which relate to the change in ownership of Ameritech, such as banker or brokerage fees, legal fees, or accounting fees, constitute legitimate costs for present purposes, only the costs associated with the utility's operations would be eligible for recovery. The Commission also agreed that "both the savings and the costs of this transaction as well as their reasonableness, must be determined when actual data, as opposed to estimates, are available."

Employee-Related Transaction Costs

The Commission's initial Order did not specifically address the appropriateness of the inclusion of certain employee-related costs as an offset to merger savings, and their resultant recovery from ratepayers, despite the following concerns expressed by the Staff:

> ...the Commission has previously ... limited the amount of severance costs that can be recovered from ratepayers in evaluating the reasonableness of merger related costs and savings. (Central Telephone Company of Illinois ("Centel"), Docket 93-0252, pp. 7-14) The Commission should also consider whether employee bonuses related solely to the closing of the merger should be recovered from ratepayers and, if so, a reasonable amount for such bonuses.
>
> The severance plan associated with a merger is significantly more generous than the severance plan absent a merger. The severance plan associated with a merger is also significantly more generous than the amount (limited to no more than one year's salary per employee) allowed in the Centel/Sprint merger referenced above. For example, an Ameritech employee with 25 years of service will receive two full year's salary with the second year's salary grossed up for taxes in the event of a merger, but would receive a maximum of 58% of one year's salary not grossed up for taxes absent a merger. As a result, absent detailed cost information it is not possible to calculate a proposed adjustment to the costs provided by the Joint Applicants.

In her Dissenting Opinion Commissioner Ruth Kretschmer criticized the Order for its lack of specificity on certain topics, and noted that for the most part the issue of netting costs against savings was not discussed. Commissioner Kretschmer's Dissenting Opinion expressed specific concerns about the recovery of the following items:

- Costs associated with the third party auditor or a third party tester ordered by the Commission.
- Reports dealing with various compliance issues to be filed by the Joint Applicants.
- The amounts of bonus payments and retirement packages to Ameritech executives stemming from the merger.
- The cost of penalties which may or may not be imposed upon the Joint Applicants, as defined in the Order.
- Costs of transferring employees to or from Texas.
- The costs of implementing Commission conditions and the costs of auditors to ensure compliance with the conditions.

In October and November 1999, a number of parties filed applications for rehearing or clarification of the ICC September 23, 1999 Order in Docket No. 98-0555. Among the issues raised were the appropriateness of the recovery of certain costs:

- Staff proposed that third party auditing costs should not be netted against merger savings or otherwise recovered from ratepayers, and requested that the administrative costs of the Consumer Education and Consumer Technology Funds not be recovered from ratepayers.
- The Citizens Utility Board (CUB) echoed the cost concerns of Commissioner Kretschmer, requesting that the Commission clarify the treatment of items such as the "golden parachutes" awarded as a result of the merger, relocation costs, and the penalties invoked should Commission conditions not be met.
- The Cook County State's Attorney's Office also cited Commissioner Kretschmer's concerns finding the Commission's definition of allowable costs to be "incredibly vague" and argued that the Joint Applicants should not be allowed to net the cost of complying with conditions imposed by the Commission against savings.

In its Amendatory Order on Rehearing, the Commission clarified its position regarding recoverable costs, expanding its list of merger transaction costs to include items raised in the Applications for Rehearing. These costs include certain employee-related costs such as employee retention payments, employee change in control payments, employee severance costs, and employee relocation costs.

> Consistent with granting the AG, Cook County and CUB applications, in part, the Order will be amended in the following respects in order to clarify the meaning of merger "costs" to be excluded.

Order at 147:

> As for the meaning of "costs", the Commission agrees with Staff that none of the merger "transactional costs" shall constitute legitimate costs for present purposes. "Transactional costs" shall be defined as those costs and expenses incurred in connection with the merger transaction and shall include but not be limited to fees and expenses of financial advisors and consultants and lawyers; filing fees; proxy costs; the costs of securing regulatory approval of the transaction; employee retention payments; employee change in control payments; employee severance costs; employee relocation costs; the costs of third party auditing or technical assistance necessary to comply with the conditions imposed by the Commission in this Order; the administrative costs associated with the Consumer Education and Community Education funds; and the costs of penalties should conditions and benchmarks imposed by the Commission in this Order not be met. It is only [those] costs directly associated with AI's provision of service which qualify under Section 7-204(c). Hence, we agree with Staff's position to allow recovery of only those costs directly associated with the utility's operation.

Order at 149:

> To be specific, Ameritech Illinois is required to track its share of all actual merger-related savings and all merger-related costs, as herein defined, separately for the period beginning on the date that the merger is consummated and ending on December 31, 1999. As noted earlier, merger-related costs shall not include "transactional costs."

1999 Reported Costs and Savings

As required by the Commission, the Company filed its "1999 Report of Recordation of All Savings and Costs for the Period Ended December 31, 1999" (1999 Costs and Savings Report or 1999 Report) in April 2000. Information was provided by Uniform System of Account (USOA) account number, with the net amount reduced for costs attributable to non-regulated activities. After intrastate allocation, the Company reported a negative savings (net cost) of $1.2 million applicable to its regulated activities in Illinois as shown in Exhibit RCS-1 (pages following.)

To comply with the reporting requirements, the Company established specific tracking codes to capture costs related to the merger transition. These costs included both employee-related costs and non-employee related expenses such as vendor charges. The Company's accounting system was used to accumulate the charges to each of the tracking codes. Savings associated with each tracking code were calculated separately.

The SBC 1999 merger costs and savings amounts were assigned to USOA account and then allocated to Ameritech Illinois for reporting purposes. The allocation to Ameritech Illinois involved two basic steps designed to mirror the normal processing of transactions in the Company's accounting systems:

1. Determination of Ameritech Illinois Total Cost and Savings

    - The cost or saving amount was assigned to a specific USOA account. Some activities impacted several USOA accounts and the total was allocated to these accounts based on Company historical data.

    - For USOA accounts where costs have historically involved billing to non-regulated affiliates, a factor was applied to associate merger costs and savings with non-regulated billings.

    - The Company then applied an allocation factor specific to AI based on the cost or savings item entity (SBC, AIT, ASI, or AI)

2. Determination of Ameritech Illinois Regulated/Intrastate Net Savings

    - Merger savings and costs for each USOA account were netted to determine net savings or net costs.

    - The Part 64 allocation factor was applied to the net cost or savings in each USOA account to determine the regulated and non-regulated amounts.

    - The Intrastate separation factor was applied to determine the regulated intrastate net cost or savings for each USOA account.

Exhibit RCS-1
1999 Reported Illinois Costs and Savings
(Dollars in Thousands)

						To Separations					Intrastate	
Plant Specific Operations Expense	Account Number	Merger Savings	Integration Cost	Net Savings (Costs)	Part 64 Allocation Factor	Merger Savings	Integration Cost	Net Savings (Costs)	Intrastate Separations Factor	Merger Savings	Integration Cost	Net Savings (Costs)
Network Support Expense	6110			-		-	-	-		-	-	-
Motor Vehicle Expense	6112			-	0.8786	-	-	-	0.779282	-	-	-
Aircraft Expense	6113			-	0.0000	-	-	-	0.779282	-	-	-
Special Purpose Vehicles Expense	6114			-	0.0000	-	-	-	0.779282	-	-	-
Garage Work Equipment Expense	6115			-	0.8524	-	-	-	0.779282	-	-	-
Other Work Equipment Expense	6116			-	0.8717	-	-	-	0.779282	-	-	-
General Support Expense	6120			-		-	-	-		-	-	-
Land and Buildings Expense	6121			-	0.8892	-	-	-	0.779282	-	-	-
Furniture and Artworks Expense	6122			-	0.8160	-	-	-	0.779282	-	-	-
Office Equipment Expense	6123			-	0.8189	-	-	-	0.779282	-	-	-
General Purpose Computers Expense	6124	2	588	(586)	0.8680	2	510	(509)	0.779282	1	398	(396)
Central Office Switching Expense	6210			-		-	-	-		-	-	-
Analog Electronic Expense	6211			-	1.0000	-	-	-	0.764115	-	-	-
Digital Electronic Expense	6212			-	0.9236	-	-	-	0.764115	-	-	-
Electro-Mechanical Expense	6215			-	1.0000	-	-	-	0.764115	-	-	-
Operators System Expense	6220			-	0.9952	-	-	-	0.764115	-	-	-
Central Office Transmission Expense	6230			-		-	-	-		-	-	-
Radio Systems Expense	6231			-	1.0000	-	-	-	0.764115	-	-	-
Circuit Equipment Expense	6232			-	0.9776	-	-	-	0.764115	-	-	-
Information Orig/Term Equipment Expense	6310			-		-	-	-		-	-	-
Station Apparatus Expense	6311			-	0.0000	-	-	-	0.750000	-	-	-
Large Private Branch Exchange Expense	6341			-	0.0000	-	-	-	0.750000	-	-	-
Public Telephone Terminal Equipment Exp	6351			-	0.0000	-	-	-	0.750000	-	-	-
Other Terminal Equipment Expense	6362			-	0.3327	-	-	-	0.750000	-	-	-
Cable and Wire Facilities Expense	6410			-		-	-	-		-	-	-
Poles Expense	6411			-	0.9981	-	-	-	0.752935	-	-	-
Aerial Cable Expense	6421			-	0.9958	-	-	-	0.752935	-	-	-
Underground Cable Expense	6422			-	0.9987	-	-	-	0.752935	-	-	-
Buried Cable Expense	6423			-	0.9960	-	-	-	0.752935	-	-	-
Submarine Cable Expense	6424			-	1.0000	-	-	-	0.752935	-	-	-
Deep Sea Cable Expense	6425			-	0.0000	-	-	-	0.752935	-	-	-
Intrabuilding Network Cable Expense	6426			-	1.0000	-	-	-	0.752935	-	-	-
Aerial Wire Expense	6431			-	0.0000	-	-	-	0.752935	-	-	-
Consuit Systems Expense	6441			-	0.9986	-	-	-	0.752935	-	-	-

Exhibit RCS-1
1999 Reported Illinois Costs and Savings
(Dollars in Thousands)

	Account Number	Merger Savings	Integration Cost	Net Savings (Costs)	Part 64 Allocation Factor	To Separations Merger Savings	To Separations Integration Cost	To Separations Net Savings (Costs)	Intrastate Separations Factor	Intrastate Merger Savings	Intrastate Integration Cost	Intrastate Net Savings (Costs)
Plant Non-Specific Operations Expense												
Other Property, Plant and Equipment Use				-		-	-	-		-	-	-
Property Held for Future	6510			-		-	-	-		-	-	-
Telecommunications Use	6511			-	0.0000	-	-	-	0.760376	-	-	-
Provisioning Expense	6512		1	(1)	0.8567	-	1	(1)	0.760376	-	1	(1)
Network Operations Expense	6530			-		-	-	-		-	-	-
Power Expense	6531			-	0.9888	-	-	-	0.758362	-	-	-
Network Administration Expense	6532	5	76	(71)	0.9929	5	75	(70)	0.758362	4	57	(53)
Testing Expense	6533			-	0.8747	-	-	-	0.758362	-	-	-
Plant Operations Administration Expense	6534		17	(17)	0.7792	-	13	(13)	0.758362	-	10	(10)
Engineerign Expense	6535		28	(28)	0.9791	-	27	(27)	0.758362	-	21	(21)
Access Expense	6540			-	1.0000	-	-	-	0.848610	-	-	-
Depreciation and Amortization Expense	6560			-		-	-	-		-	-	-
Depreciation Expense - Telecommunications				-		-	-	-		-	-	-
Plant in Service	6561			-	0.9751	-	-	-	0.756419	-	-	-
Depreciation Expense - Property Held for				-		-	-	-		-	-	-
Future Telecommunications Use	6562			-	0.0000	-	-	-	0.756419	-	-	-
Amortization Expense - Tangible	6563			-	0.8978	-	-	-	0.756419	-	-	-
Amortization Expense - Intangible	6564			-	0.0000	-	-	-	0.756419	-	-	-
Amortization Expense - Other	6565			-	0.8671	-	-	-	0.756419	-	-	-
Customer Operations Expense												
Marketing	6610			-		-	-	-		-	-	-
Product Management	6611	13	45	(32)	0.9510	12	43	(30)	0.787618	10	34	(24)
Sales	6612	14	62	(48)	0.8833	12	55	(42)	0.787618	10	43	(33)
Product Advertising	6613			-	0.8797	-	-	-	0.787618	-	-	-
Services	6620			-		-	-	-		-	-	-
Call Completion Services	6621		3	(3)	1.0000	-	3	(3)	0.850655	-	3	(3)
Number Services	6622			-	1.0000	-	-	-	0.850655	-	-	-
Customer Services	6623	1	386	(385)	0.7735	1	299	(298)	0.809719	1	242	(241)

Exhibit RCS-1
1999 Reported Illinois Costs and Savings
(Dollars in Thousands)

						To Separations				Intrastate		
Corporate Operations Expense	Account Number	Merger Savings	Integration Cost	Net Savings (Costs)	Part 64 Allocation Factor	Merger Savings	Integration Cost	Net Savings (Costs)	Intrastate Separations Factor	Merger Savings	Integration Cost	Net Savings (Costs)
Executive and Planning	6710			-		-	-	-		-	-	-
Executive	6711	10		10	0.8666	9	-	9	0.776965	7	-	7
Planning	6712	50		50	0.9138	46	-	46	0.776965	35	-	35
General and Administrative	6720			-		-	-	-		-	-	-
Accounting and Finance	6721	64	371	(307)	0.9063	58	336	(278)	0.776965	45	261	(216)
External Relations	6722	76	310	(234)	0.9405	71	292	(220)	0.776965	56	227	(171)
Human Resources	6723	113	262	(149)	0.8676	98	227	(129)	0.776965	76	177	(100)
Information Management	6724	32	119	(87)	0.8677	28	103	(75)	0.776965	22	80	(59)
Legal	6725	2	12	(10)	0.8847	2	11	(9)	0.776965	1	8	(7)
Procurement	6726	2	12	(10)	0.9835	2	12	(10)	0.776965	2	9	(8)
Research and Development	6727			-	0.9098	-	-	-	0.776965	-	-	-
Other General and Administrative	6728	110	1	109	0.9589	105	1	105	0.776965	82	1	81
Provision for Uncollectible Notes Receivable	6790			-	0.0000	-	-	-	0.776965	-	-	-
		494	2,293	(1,799)		451	2,008	(1,557)		351	1,570	(1,220)

Employee-Related Costs

In connection with the merger, Ameritech incurred a number of employee-related costs including:

- Payments under Services and Non-Compete Agreements and other retention bonuses paid or to be paid to retain the services of key executives and employees.
- Change in Control and severance payments to members of the Executive Committee and Ameritech Management.
- Relocation payments to employees who were transferred to different offices.
- Stock options which fully vested upon a change in control. Under generally accepted accounting principles, the accounting for stock options has no merger cost or savings implications. However, there is a monetary benefit to employees and an economic cost to the Company as discussed later in this chapter of the report.

Certain of these costs have been treated as "below-the-line;" however, a portion of these costs have been netted against savings in the Company's 1999 Costs and Savings Report filed with the Illinois Commerce Commission on April 7, 2000. The Company's treatment of employee-related costs is summarized in Exhibit RCS-2 below.

Exhibit RCS-2
Summary of Treatment of Employee-Related Costs

Category	Treatment	Includes
Executive Committee Costs	Below-the-line (transaction costs)	Change in control payments, retention payments, other bonuses, and consulting agreements.
Severance Payments (Non-Executive Committee)	Netted against savings in 1999 Report	Corporate Resource Severance Pay Plan and Ameritech Management Employee Severance Pay Plan payments.
Relocation Costs	Netted against savings in 1999 Report	Transfer of Ameritech and non-Ameritech employees.

Source: Verification Response ALA-7.

Exhibit RCS-3 (following) provides a listing of merger-related payments for which various classifications of Ameritech employees are eligible. Specific elements of employee merger-related compensation are discussed in greater detail below.

Exhibit RCS-3
Eligibility for Merger-Related Compensation

Employee Classification or Individual	Merger-Related Compensation
Chairman of the Board and CEO (1 employee)	• Services and Non-Compete Agreements • Services and Non-Compete Agreement Bonus • Performance and Retention Bonus • Change in Control Payments • Stock Options Vest
Executive Committee (7 employees)	• Services and Non-Compete Agreements • Change in Control Payments • Stock Options Vest
Other Executive Officers (7 employees)	• Corporate Resource Severance Pay Plan • Stock Options Vest
Ameritech Management Employees	• Corporate Resource Severance Pay Plan • Ameritech Management Employees Severance Pay Plan • Stock Options Vest

Source: BWG Analysis, Amendment No. 2 to Form S-4, as filed with the SEC on September 21, 1998 (Document Request ICC 1, Question 12); Amendment No. 3 to Form S-4, as filed with the SEC on October 15, 1998; Change in Control Agreements, Services and Non-Compete Agreements and Severance Packages (Document Requests JDH 3.2 and JDH 3.3.)

Employee Retention Payments

As a result of the merger, the Company has and will continue to incur costs to retain the services of key employees. These payments totaled $9.8 million in 1999 as shown in Exhibit RCS-4 (following) and have not been netted against savings in the Company's 1999 Costs and Savings Report.

Exhibit RCS-4
Retention Payments
(Dollars in Thousands)

Employee Classification	Nature of Retention Payment	1999 Amount
CEO	• Services and Non-Compete Agreement Consulting Wages • Services and Non-Compete Agreement Bonus • $2.5 million bonus	$1,167 4,257 2,500
Executive Committee (7 additional officers)	• Services and Non-Compete Agreement Consulting Wages	1,850
Ameritech Management	• No payments in 1999, however, payments may have been made in 2000.	0
Total		$9,774

Source: Amendment No. 2 to Form S-4, as filed with the SEC on September 21, 1998 (Document Request ICC 1, Question 12); and Verification Request ALA 7.

On May 10, 1998, SBC entered into Services and Non-Compete Agreements with eight executive officers of Ameritech. The Services and Non-Compete Agreements provide that each of these officers will be employed or retained as a consultant by SBC or a subsidiary of SBC for a period of up to 30 months commencing on the effective date of the merger and will provide services to the combined company as a member of senior management as required by SBC during the transition and integration period. The Service Agreements acknowledge that termination of the executive officer's status as a full-time employee under the Services and Non-Compete Agreements would constitute an involuntary termination for purposes of the Change in Control Agreements. The compensation for these eight executives under the Services and Non-Compete Agreements is in addition to the Change in Control Payments and totals $18.1 million annually as shown in Exhibit RCS-5 (following).

Exhibit RCS-5
Payments under Services and Non-Compete (Consulting) Agreements
(Dollars in Thousands)

Executive Officer	Annual Payment	1998 Salary and Bonus
Chairman of the Board and CEO	$7,000	$3,019
Executive VP and CFO	2,300	1,124
Executive VP Regulatory and Wholesale Operations	2,000	947
Executive VP Corporate Strategy and Business Development	1,800	956
Executive VP Communications and Information Products	1,600	833
Three Other Executive Officers	3,400	
Total	$18,100	

Source: Amendment No. 2 to Form S-4, as filed with the SEC on September 21, 1998, p. 60 (Document Request ICC 1, Question 12); and Notice of 1999 Annual Meeting and Proxy Statement (Document Request JDH 1.3).

The Services and Non-Compete Agreements also provide that the CEO receive a bonus for the year in which the Merger is consummated in an amount equal to $1,331,000 multiplied by the percentage by which the bonus paid to the Chief Executive Officer of SBC for such year exceeds his base salary (this bonus totals $4,257,000 as shown in Exhibit RCS-4). In addition, these agreements provide that the Chief Financial Officer (CFO) will be treated as having fully earned his pension supplements pursuant to his supplemental pension arrangement entered into with Ameritech in 1995, and also will qualify for certain post-retirement benefits.

Upon termination of employment, unless the non-competition clause is violated, the Services and Non-Compete Agreements provide that each executive officer shall receive financial consulting assistance for a period of five years under SBC'S standard policies for retiring executives, and, in addition, the CEO will receive office space and secretarial support.

On May 10, 1998, the Ameritech Board of Directors approved the grant to the Ameritech CEO of a retention and performance bonus of $2.5 million payable on the earlier of the effective date of the merger or September 1, 1999. The bonus was paid by Ameritech to retain the CEO's services and to compensate him for the increased demands and responsibilities placed upon him during this period. The bonus is in addition to all other amounts to be paid to the CEO.

Change in Control and Severance Payments

As shown in Exhibit RCS-6, Ameritech made merger related change in control and severance payments under three different plans. Two of these plans providing for payments to Ameritech management employees were first adopted in 1989 and amended slightly in May 1998 to substantially freeze eligibility. Change in Control Payments to members of the Executive Committee were made pursuant to individual agreements, most of which were entered into in the mid-1990's and contain substantially the same provisions.

Exhibit RCS-6
Change in Control Severance Plans

Plan	Lump Sum Payment
Change in Control Payments (Executive Committee)	2.99 times base salary and incentive awards plus the actuarial equivalent of additional pension benefits that would have accrued if the employee had been credited with two additional years of service and compensation.
Corporate Resource Severance Pay Plan (Ameritech Management Employees)	2 times base salary and incentive awards plus the actuarial equivalent of additional pension benefits that would have accrued if the employee had been credited with two additional years of service and compensation.
Ameritech Management Employees Severance Pay Plan (Ameritech Management Employees)	1 times base salary and incentive awards plus 4% of base salary times number of years of employment grossed up for taxes.

Source: Change in Control Agreements and Severance Packages (Document Requests JDH 3.2 and 3.3).

Executive Committee and Executive Officers

Ameritech entered into Change in Control Agreements with eight executive officers of Ameritech, prior to the merger, while each officer was still employed. The Change in Control Agreements were developed "to assure continued attention of the Executive to his duties without any distraction arising out of uncertain personal circumstances in a change in control environment." These agreements provided that, if the executive officer's employment with Ameritech was terminated under specified circumstances, the executive officer would continue to receive certain medical, insurance and other employee benefit coverage and perquisites for a period of 24 months following such termination, and would receive a lump sum severance payment. Exhibit RCS-7 (following) outlines the terms of the Change in Control Agreement.

Exhibit RCS-7
Change in Control Agreement Terms

Category	Compensation After a Change in Control
Existing Compensation	
Base Salary	• No reduction during the 24 month period in which the Executive is employed after Change in Control
Long and Short-Term Incentives and Bonuses	• No reduction during the 24 month period in which the Executive is employed after Change in Control
Employee Benefits (medical insurance, disability income protection, life insurance and death benefits)	• No reduction during the 24 month period in which the Executive is employed after Change in Control • If terminated within 24 months following a change in control, continue to receive benefits for 24 months following termination
Fringe Benefits and Perquisites to which executive was entitled prior to the Change in Control (CIC)	• No reduction during the 24 month period in which the Executive is employed after Change in Control • If terminated within 24 months following a change in control, continue to receive benefits for 24 months following termination
Severance Payments	Equal to the sum of: (i) 2.99 times the executive officer's annual base rate in effect immediately prior to the CIC, plus (i) 2.99 times the executive officer's short-term incentive award and other bonuses payable for the calendar year preceding the CIC, plus (iii) actuarial equivalent of additional pension benefits that would have accrued if the employee had been credited with two additional years of service and compensation

Source: Change in Control Agreements (Document Request JDH 3.2).

Under the terms of the Change in Control Agreements, SBC made lump sum payments to five of the eight executives totaling (redacted) in 1999, and will pay out an additional (redacted) to the remaining three executives in 2000, for a total of (redacted), as shown in Exhibit RCS-8 (following).

Exhibit RCS-8
Lump Sum Change in Control Payments
(Dollars in Thousands)

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Ameritech Management Employees

Ameritech management employees are provided merger-related severance benefits under one of two plans originally adopted in 1989 and specifically designed to address a change in control:

1. Corporate Resource Severance Pay Plan - Employees in salary grades CR1 through CR9, Investment Management salary grades IM10 though IM12, or Attorney salary grades IV through VI.

2. Ameritech Management Employee Severance Pay Plan – Tier B and below management employees up through salary grade 9 who are eligible to participate the Ameritech Management Employee Pension Plan, but not eligible for CRSPP.

Approximately 220 members of Ameritech management (including seven executive officers) participate in the Corporate Resource Severance Pay Plan (CRSPP), which provides for severance payments upon termination of employment after a change in control. CRSPP provides that base salaries and certain incentive and benefit plans for participating employees will not be materially reduced during the 24 month period following the merger should the participant continue to be employed following the Change in Control, and provides for a severance benefit to employees who are terminated. Exhibit RCS-9 outlines the terms of the severance benefits under CRSPP.

Exhibit RCS-9
Corporate Resource Severance Pay Plan Benefits

Category	Compensation After a Change in Control
Lump Sum Payment	Equal to the sum of: (i) two times the participant's annual base salary as of the date of the CIC, plus (i) two times the participant's target short-term incentive amount and other bonuses payable for the for the calendar year preceding the CIC, plus (iii) actuarial equivalent of additional pension benefits that would have accrued if the employee had been credited with two additional years of service and compensation
Medical insurance, disability income protection, life insurance and death benefits, and perquisites	• Continue to receive benefits for not less than 24 consecutive months
Ameritech Key Management Life Insurance Plan Ameritech Estate Preservation Plan	• Company will continue to contribute for not less than 24 consecutive months amount needed to maintain death benefit

Source: Amendment No. 2 to Form S-4, as filed with the SEC on September 21, 1998 (Document Request ICC 1, Question 12); and Corporate Resource Severance Pay Plan (Document Request JDH 3.2).

As shown in Exhibit RCS-10 (page following), SBC estimates that severance payments under CRSPP will total $116.4 million (regulated and non-regulated), $15.0 million of which was incurred in 1999 ($8.3 million non-regulated and $6.7 million regulated). Of the $6.7 million in severance payments to employees of regulated entities, approximately $535,000 was billed out in 1999, resulting in an allocation of $93,000 to AI, which was applied as an offset to savings in the 1999 Report. The remaining $6.1 million will be billed out in 2000. This does not include the cost of insurance and other benefits or perquisites the employees continue to receive and the Company has not yet attempted to specifically identify or quantify these costs.

Exhibit RCS-10
Corporate Resource Severance Pay Plan Benefits
(Dollars in Thousands)

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Ameritech management employees who participate in the Ameritech Management Pension Plan, but are not eligible for CRSPP are eligible to participate in the Ameritech Management Employees Severance Pay Plan, which provides severance benefits in the event of a change in control. Exhibit RCS-11 outlines the severance benefits under the Ameritech Management Employees Severance Pay Plan.

Exhibit RCS-11
Severance Benefits Under the Ameritech
Management Employees Severance Pay Plan

Category	Compensation After a Change in Control
Lump Sum Payment	Equal to the sum of: (i) Annual Base Compensation, plus (ii) 4% times Annual Base Compensation times the number of years of full time employment (up to 25) Where the Annual Base Compensation equals base salary, plus annual target performance award and other bonuses for the year in which the change in control occurs, plus average of sales commission payments for two preceding years.

Source: Ameritech Management Employees Severance Pay Plan (Document Request JDH 3.3)

Non-Change in Control Severance Plans

While the CRSPP and Ameritech Management Employee Severance Pay Plan provide severance benefits upon a change in control, they differ from benefits that were available absent a change in control. Absent a change in control, Tier B and below management employees were eligible for benefits under the Management Separation Benefit Plan. Employees eligible for change in control benefits under the CRSPP were not eligible for benefits under the Management Separation Benefit Plan. Prior to the merger, Ameritech did not have a specific severance plan for management employees in this group. Severance payments were determined on a case-specific basis or under individual agreements entered into at the time of employment. The CRSPP and Ameritech Management Employee Severance Pay Plans were adopted in 1989 to address potential changes in control, and were not specifically developed to address the SBC/Ameritech merger. Differences in the severance plans are shown in Exhibit RCS-12 below.

Exhibit RCS-12
Ameritech Severance Plans

Employee Classification	Change in Control Severance Plan	Severance Plan Absent Change in Control
Employees in salary grades CR1 through CR9 Investment Management salary grades IM10 though IM12 Attorney salary grades IV through VI	CRSPP	No specific plan - amounts negotiated.
Tier B and below management employees up through salary grade 9 who are eligible to participate in the Ameritech Management Employee Pension Plan, but not eligible for CRSPP	Ameritech Management Employee Severance Pay Plan	Management Separation Benefit Plan

Source: Severance Packages (Document Requests JDH 3.2 and JDH 3.3); Management Separation Benefit Plan and Summary Plan Description Commencing on January 1, 1995 (Document Request ALA-Verbal); and Eligibility Confirmation (Document Response ALA 24).

A comparison of the benefits for Tier B and below management employees under the Ameritech Management Employee Severance Pay Plan and the Management Separation Benefit Plan is provided in Exhibit RCS-13. As CRSPP eligible employees did not have a standard severance plan without a change in control, no comparison can be made.

Exhibit RCS-13
Severance Benefit Comparison
Management Separation Benefit Plan vs. Ameritech Management Employee Severance Pay Plan
(Dollars in Thousands)

Plan Provision	Management Separation Benefit Plan	Ameritech Management Employee Severance Pay Plan
Eligibility	Tier B and below management employees up through salary grade 9 or its equivalent	Employees eligible to participate in the Ameritech Management Pension Plan excluding employees eligible for CRSPP
Lump Sum	8% of base compensation plus 3% base compensation times number years service	Base compensation plus 4% of base compensation times number years service grossed up for taxes
Years of Service	Caps at 14	Caps at 25
Base Compensation includes:		
Salary	Yes	Yes
Bonuses	No	Yes
Sales Commissions	No	Yes
Tuition Reimbursement	Yes	No
Medical, Dental and Vision	6 months	None
Disability Income	No	No
Life Insurance Protection and Death Benefits	No	No
Perquisites	No	No
Contribution to Pension	No	No

Source: Management Separation Benefit Plan and Summary Plan Description Commencing on January 1, 1995 (Document Request ALA-Verbal); Ameritech Management Employees Severance Pay Plan (Document Request JDH 3.3.)

Stock Options

At the date of the merger, Ameritech had approximately 44 million optioned shares outstanding of which approximately 25 million shares were exercisable. The options have a maximum life of ten years and one day and become exercisable after one year from the date of grant in equal increments over the following three years. Under Change in Control Agreements in effect at the date of the merger, approximately 19 million shares became immediately exercisable. The aggregate difference between the option price and stock closing price at the date of the merger of these 19 million shares was approximately $419 million.

Under Statement of Financial Accounting Standards No. 123 (FAS 123), *Accounting for Stock-Based Compensation*, issued by the Financial Accounting Standards Board (FASB) in

1995, the value of stock options at the date of grant must be calculated using an option pricing model. Like most companies, Ameritech elected the "pro forma, disclosure only" option permitted by FAS 123 and recorded no compensation expense relating to the options. However, with the immediate vesting of the options, the intended compensation value changed because of the failure of the original assumptions in the pricing model relating to market risk, the time frame for vesting, and potential forfeiture.

Exhibit RCS-14 (following) provides the aggregate value of the Executive Committee options measured as the difference between the February 12, 1999 closing price of $60.9375 per share and the average exercise price per share, with an assumed merger effective date of May 1, 1999, as reported in the Proxy Statement relating to Ameritech's 1999 Annual Shareholders Meeting and Amendment No. 2 to SEC Form S-4.

Exhibit RCS-14
Aggregate Value of Options as of February 12, 1999

Executive Officer	Options Which Became Exercisable	Weighted Average Exercise Price per Share	Aggregate Value of Options
Chairman of the Board and CEO	749,624	$31.4459	$22,107,633
Executive VP and CFO	344,136	36.0197	8,575,119
Executive VP Regulatory and Wholesale Operations	188,198	35.9129	4,709,580
Executive VP Corporate Strategy and Business Development	265,900	36.1507	6,590,804
Executive VP Communications and Information Products	291,498	34.7636	7,629,649
All Executive Officers as a Group (15 persons total)	2,479,578	34.5471	

Source: Amendment No. 2 to Form S-4, as filed with the SEC on September 21, 1998 (Document Request IDR 1.12); and Notice of 1999 Annual Meeting and Proxy Statement, p. 20 (Document Request JDH 1.3).

Under the terms of certain of the foregoing options, dividend equivalent shares are credited quarterly for up to five years on the shares subject to the options (and on previously credited dividend equivalent shares) by dividing the aggregate cash dividend that would have been paid on such shares had they been outstanding by the then current market price of the Ameritech Common Stock. The dividend equivalents are distributed in the form of shares of Ameritech Common Stock after the earlier of the exercise of the option or the first set distribution date which is at least five years from the date of grant on which the then current market price exceeds the exercise price.

Audit Objectives

- Verify that the Company has adequately identified and quantified one-time merger costs which relate to the change in ownership of Ameritech. Such costs include, but are not limited to, banker or brokerage fees, legal fees, and accounting fees. [from RFP]

- Verify that the Company has properly identified and quantified 1999 merger savings and costs that are included in the "Report of Recordation of All Savings and Costs For the Period Ending December 31, 1999" (1999 Report) submitted to the Commission.

- Ensure that the costs included in the 1999 Report meet the criteria established by the Commission.

- Verify that the one-time merger costs are not included in the 1999 Cost and Savings Report.

Evaluative Criteria

- Are one-time merger costs related to the change in ownership appropriately identified and accounted for?

- Are one-time merger transaction costs excluded from the 1999 Cost and Savings Report?

- Has the Company properly identified and quantified merger savings and costs that it has included in the 1999 Cost and Savings Report?

- Does the 1999 Cost and Savings Report include costs which do not meet the Commissions requirements?

Summary of Audit Procedures

- Reviewed the Commission Order, Amended Order and Testimony to identify cost and savings reporting requirements.

- Tested one-time merger costs as reported by SBC/Ameritech to determine whether they were reported in compliance with the Commission rulings.

  ⇒ Determined the source of one-time merger costs and obtained supporting detail by month and transaction category.

  ⇒ Obtained transaction level detail for selected months and transaction categories. Traced specific charges to underlying source documents on a test basis.

  ⇒ Determined how such costs will be apportioned to Ameritech Illinois.

- Assessed the appropriateness of the Company's treatment of 1999 reported costs and savings.

- Quantified the difference between actual merger related severance payments and estimated payments absent a merger.

- Assessed controls and processes established to ensure transaction costs are not included as an offset to savings.

- Reviewed all costs as reported by SBC/Ameritech in its 1999 Report to determine whether they are in compliance with the Commission rulings.

  ⇒ Determined the source of the costs and obtained supporting detail by month and transaction category.

  ⇒ Traced specific charges to underlying source documents on a test basis.

- For categories of costs identified by the Commission in the Amended Order as transaction costs, determined whether such costs are included in the 1999 Report. To the extent necessary, determined why any such incurred costs were included.

- Determined how 1999 reported costs and savings are apportioned to Ameritech Illinois and the reasonableness of the allocation methods and amounts.

- Quantified adjustments resulting from the work in this area of the investigation.

- Prepared a task report.

Questioned Costs

Some categories of cost and savings included in the Company's 1999 Costs and Savings Report are based upon the Company's interpretation of applicable regulatory principles. In some cases we believe there are appropriate alternatives, and use the term "questioned costs" to bring to the Commission's attention those matters requiring its interpretation and approval or which lack adequate support. In this manner, our work can be used by the Commission to narrow the scope of items requiring additional review.

Findings and Conclusions

Reporting Requirements

1. As required by the Commission's Amended Order, the Company filed its 1999 Cost and Savings Report for the period ended December 31, 1999 in April 2000. While the Company has complied with the Commission's reporting requirements, the use of USOA accounts alone does not allow for specific identification of areas of potential interest to the Commission.

   - In its September 23, 1999 Order, the Commission required AI to track all merger-related costs and savings between the date the merger is consummated and December 31, 1999 and submit information relating to the tracking of such costs by USOA account as part of the Alternative Regulation filing due April 1, 2000. Information on merger-related costs and savings is to be submitted annually thereafter, until such time as an updated price cap formula has been developed. The required report was filed on April 7, 2000. Exhibit RCS-1 (provided previously) is a summary of the reported merger costs and savings for Illinois.

- In the reporting of 1999 costs and savings, the Company established a number of tracking codes for use in accumulating merger savings and costs. Costs associated with each of these tracking codes were then allocated to Ameritech Illinois by USOA account for compliance with the Commission's reporting requirements. The tracking codes and the associated descriptions provide additional detail needed for a complete understanding of the nature of the underlying costs. A breakdown of Ameritech Illinois 1999 costs and savings by tracking code is provided in Exhibit RCS-15 (page following).

- The USOA accounts provide data at a functional level, but do not provide specific breakdowns of costs and savings that might be of interest to the Commission such as severance or relocation costs.

2. In the 1999 Cost and Savings Report, the Company netted \$1.6 million of costs against reported savings of \$0.4 million for a negative net savings of \$1.2 million.

    - The Commission found that to the extent that costs are incurred to produce savings and are shown to be both reasonable and directly related, netting is appropriate.

    - As shown in Exhibit RCS-16 (page following), a number of costs were incurred in 1999 that produced no savings in 1999, and certain costs cannot be directly tied to future savings.

    - For example, the Company has allocated \$548,000 of costs to Illinois to convert to a common e-mail system. However, we found no evidence of direct savings related to this expenditure in the information provided by the Company. The inclusion of the e-mail conversion costs as offsets to savings is further discussed in Finding No. 7 below.

    - It is the Company's position that there is no requirement that costs and savings must occur in the same year, and, in general, that costs for an initiative will be incurred before savings are realized.

Exhibit RCS-15
Ameritech Illinois 1999 Merger Costs and Savings
(Dollars in Thousands)

Tracking Code or Category	Description	Merger Savings	Integration Cost	Net (Costs) Savings
Severance	Avoided salaries and wages, and associated severance costs for AI and ASI. Excludes activity associated with employees severed from positions that were backfilled and Executive Committee costs.	$63	$651	($587)
AIT Savings	Avoided salaries and wages for AIT. Savings reflect only those amounts associated with Ameritech Corporation. Does not reflect any integration costs. Excludes activity associated with employees severed from positions that were backfilled and Executive Committee costs.	108	-	108
SBCCT	Costs incurred by IT's participation in merger core teams. Costs reflect only those amounts incurred by ASI.	-	16	(16)
SBDSL	Costs incurred by IT's participation in merger core teams. Costs reflect only those amounts incurred by ASI.	-	3	(3)
MERGR	Costs incurred by various individuals and organizations' participation in merger core teams. Costs reflect only amounts incurred by ASI and AI. Costs pertaining to OSS and performance measurement were excluded.	-	39	(39)
SBCIL	Costs incurred by Network organization for work pertaining to Illinois merger stipulations. Reflect only those amounts incurred by ASI and AI.	-	28	(28)
UBREB	Costs incurred by Network and IT organizations associated with merger team unbundled "rebundling." Costs reflect only those amounts incurred by ASI and AI.	-	11	(11)
UBSTR	Costs incurred by Network and IT organizations associated with unbundled shared transport. Costs reflect only those amounts incurred by ASI and AI.	-	6	(6)
2095	Costs incurred by Ameritech Corporate organizations (primarily Product Management) for work pertaining to merger compliance activities.	-	6	(6)
Vacancies	Avoided salaries and wages for open positions eliminated in 1999 (Public Relations, Advertising, Human Resources)	80	-	80
Implement-ation	Relocation costs billed by parent entity to affiliates for individuals in legal, finance, external affairs, corporate communications and human resources. Costs also include software licensing costs to convert Ameritech employees to a common e-mail platform (Outlook) and licensing costs of personal computer tracking software to manage these assets.	-	676	(676)
SBC01	Costs incurred by various individuals and organizations' participation in merger core teams. Reflect only those amounts incurred by ASI and AI.	-	49	(49)
SBCST	Costs incurred by IT' participation in merger core teams. Costs reflect only those amounts incurred by ASI and AI.	-	78	(78)
SBC98	Costs incurred by IT' benchmarking of SBC and Ameritech IT functions to identify cost saving opportunities. Costs reflect only those amounts incurred by AS I.	-	5	(5)
SBC99	Costs incurred by IT' benchmarking of SBC and Ameritech IT functions to identify cost saving opportunities. Costs reflect only those amounts incurred by AS I.	-	3	(3)
Non-Wage Savings	Consolidation of contractual arrangements in procurement area and net reductions in property and executive fiduciary and crime insurance costs.	99	-	99
	Total	$351	$1,571	($1,220)

Source: BWG Analysis; Support for Ameritech Illinois' Report for Recordation of All Savings and Costs For the Period Ending December 31, 1999 (Document Request DPV 1.8).

Exhibit RCS-16
Ameritech Illinois 1999 Reported Costs and Savings by Category
(Dollars in Thousands)

Category	Savings	Costs	Net Savings
Severance	171,215	650,676	(479,461)
Vacant Positions	80,306		80,306
Relocation		19,279	(19,279)
E-mail and Asset Management Software		656,880	(656,880)
Merger Compliance Expense Tracking		39,161	(39,161)
Merger Compliance		6,079	(6,079)
Illinois Stipulations		27,986	(27,986)
Procurement, Property and Insurance	99,066		99,066
Merger Team Participation (IT)		97,733	(97,733)
Merger Team Participation		49,203	(49,203)
Merger Team Benchmarking (IT)		7,597	(7,597)
Merger Team Unbundled "Rebundling"		10,502	(10,502)
Merger Team Unbundled Shared Transport		5,820	(5,820)
Total Savings Costs and (Net Savings)	$350,587	$1,570,917	$(1,220,331)

Category	Percentage of Savings	Percentage of Costs	Percentage of Net Savings
Severance	48.8%	41.4%	39.3%
Vacant Positions	22.9%	0.0%	-6.6%
Relocation	0.0%	1.2%	1.6%
E-mail and Asset Management Software	0.0%	41.8%	53.8%
Merger Compliance Expense Tracking	0.0%	2.5%	3.2%
FCC Merger Compliance	0.0%	0.4%	0.5%
Illinois Stipulations	0.0%	1.8%	2.3%
Procurement, Property and Insurance	28.3%	0.0%	-8.1%
Merger Team Participation	0.0%	9.3%	12.0%
Merger Team Benchmarking (IT)	0.0%	0.5%	0.6%
Merger Team Initiatives	0.0%	1.1%	1.4%
Total	100.0%	100.0%	100.0%

Source: BWG Analysis; and Support for Ameritech Illinois' Report for Recordation of All Savings and Costs For the Period Ending December 31, 1999 (Document Request DPV 1.8).

Questioned Costs and Controls

As summarized in Exhibit RCS-17 below, the 1999 Costs and Savings Report includes $1.3 million of merger costs allocated to Illinois that are not clearly supported by the Merger Order or Amended Order. Consistent with the requirements of the Commission's Order, the reasonableness of these costs must be determined by the Commission. These costs are discussed in further detail in the findings following Exhibit RCS-17.

Exhibit RCS-17
1999 Questioned Costs
(Dollars in Thousands)

Category	Amount Allocated to AI	Reason Questioned	Reference Conclusion
Severance Costs	$651	Possible Transaction Cost	4
Relocation Costs	19	Possible Transaction Cost	4
Compliance Costs	90	Possible Transaction Cost	5
Pre-Merger Costs (see Note)	4	Incurred pre-merger	6
E-Mail Costs	548	Not tied to future savings	7
Total	$1,312		

Note: The pre-merger costs identified in Conclusion 6 include $21,000 in compliance costs which are included in Conclusion 5 costs. To avoid double counting, only $4,000 pre-merger costs are listed in this Exhibit.

Source: BWG Analysis (Summary of conclusions below.)

3. The Company did not have sufficient procedures or training programs in place to ensure that merger transaction costs were not charged to merger implementation tracking codes, and as a result had to rely on an after-the-fact review of charges by SBC personnel to ensure transaction costs were not netted against savings in the 1999 Report.

   - Training materials, instructions or other guidelines to ensure one-time merger costs have not been inappropriately included as an offset to savings were not developed prior to the preparation of the 1999 Costs and Savings Report. The Company believes no specific instructions or guidelines were necessary because the review of all costs and savings was performed by a single individual within the MIT.

   - In August 1999, Ameritech issued an e-mail providing guidelines for the use of MERGR and 2095 (two of the merger implementation tracking codes): "Expenses you should track include expenses incurred specifically in meeting the Federal Communications Commission (FCC) Merger Conditions." Examples of these types of expenses provided in the e-mail included:

     ⇒ Accounting fees for audits and the preparation of statements and findings

     ⇒ Legal fees involved in specific filings of interconnection agreements

⇒ Costs associated with obtaining approval from regulatory bodies

⇒ Costs associated with providing specifically defined assistance to small CLECs

⇒ Costs associated with most-favored nation provisions for both in-region and national-local

⇒ All costs related to monitoring and ensuring compliance with these conditions

4. SBC's treatment of certain non-Executive Committee employee severance and relocation costs may be inconsistent with the Commission's Order and Amended Order. BWG has identified the amount of such costs ($0.7 million of severance and $19,300 of relocation costs allocated to AI in 1999) to enable the Commission to determine the appropriateness of their inclusion as an offset to merger savings.

   - While Ameritech has excluded Executive Committee severance costs from the 1999 Costs and Savings Report, severance payments to other Ameritech employees were included.

   - The Commission's Amended Order specifically identified employee retention payments, employee change in control payments, employee severance costs, and employee relocation costs as examples of "merger transaction costs" which would not qualify for recovery under Section 7-204(c), but also "agree[d] with Staff's position to allow recovery of only those costs directly associated with the utility's operations.

   - The Company states it has included as an offset to merger savings only those severance and relocation costs necessary to achieve the associated headcount reduction and consolidation savings and thus those costs should be considered recoverable. The Company believes that the determination regarding the eligibility of these costs for recovery should be made when actual data are available, based upon a review of the entire regulatory record.

   - In the Centel merger, the Commission found the Company's requested recovery of merger related severance payments of three times salary for its senior management to be unreasonable, and adopted the Staff's proposal of limiting the amount of severance pay to one times salary amortized over a five year period. The Commission found that the Staff's proposal represented a proper matching of benefits with the associated costs and provided for an equitable sharing of severance costs between shareholders and ratepayers.

   - The 1999 Costs and Savings Report includes $2.1 million of Illinois Bell and ASI employee severance costs billed in 1999 and reported as an offset to merger savings. $0.7 million of these costs are allocated to Ameritech Illinois. A breakdown of the employee severance costs included in the 1999 Report is shown in Exhibit RCS-18.

Exhibit RCS-18
Severance Costs Included in Illinois 1999 Merger Cost and Savings Report
(Dollars in Thousands)

Team	Illinois Bell	ASI	Total	Illinois Amount
10 Network Staff		$238	$238	$56
14 Consumer Sales		179	179	39
26 Finance		1,000	1,000	173
27 External Affairs	304		304	222
32 Human Resources	206	158	364	161
Total	$509	$1,575	$2,085	$651

Note: AIT Corporate costs were not billed out to the entities in 1999.

Source: Support for Ameritech Illinois' Report for Recordation of All Savings and Costs For the Period Ending December 31, 1999 (Document Request DPV 1.8).

- Severance costs that were allocated to Illinois comprised 41 percent of the 1999 reported merger costs as previously shown in Exhibit RCS-16. The associated severance savings accounted for 49 percent of the total merger savings and 39 percent of the net savings reported in 1999.

- Approximately $25.6 million of additional severance costs are not included in the 1999 Costs and Savings Report, but according to the Company will be considered for inclusion in the year 2000 cost and savings report. Based upon Company estimates, this could result in an allocation of $1.2 million in cost to AI.

- The 1999 Costs and Savings Report includes approximately $604,000 in relocation costs as an offset to merger savings. Approximately $19,000 was allocated to the Illinois regulated jurisdiction.

  ⇒ The Company's rationale for including these costs is that the relocations will result in savings from the consolidation of offices and the elimination of duplicate positions and that relocation expenses are necessary to affect a consolidation.

  ⇒ While the Company position has merit, the Commission's Amended Order specifically identified employee relocation costs as examples of "merger transaction costs" which would not qualify for recovery under Section 7-204(c),

  ⇒ Four of the 29 relocations involved Ameritech employees. Of the remaining 25, only one was a relocation to the Ameritech service territory.

5. The 1999 Costs and Savings Report includes approximately $463,000 of merger costs associated with compliance activities. $90,000 of these costs are allocated to AI. The inclusion of these costs in the 1999 Costs and Savings Report is not clearly supported by the Merger Order or Amended Order.

- According to the Merger Order, none of the one-time merger costs that relate to the change in ownership constitute reportable costs. Although the Amended Order does not specifically address the costs associated with compliance with FCC and ICC merger conditions, it does specifically classify as transaction costs the "costs of securing regulatory approval of this transaction" and "the costs of third party auditing or technical assistance necessary to comply with the conditions imposed by the Commission in this Order."

- On August 16, 1999 Ameritech circulated an e-mail describing the nature of expenses which should be charged to merger compliance tracking codes MERGR and 2095. The e-mail indicated that the "Federal Communications Commission (FCC) has proposed a variety of requirements as conditions to approving the SBC-Ameritech merger" and requested that expenses incurred be tracked. An example of the types of activities to be charged to these accounts was previously provided in Finding No. 3.

- A breakdown of the costs of compliance activities included in the 1999 Costs and Savings Report is shown in Exhibit RCS-19 (following).

Exhibit RCS-19
Compliance Tracking Codes
(Dollars in Thousands)

Tracking Code	Initiative Code Description	Amount Allocated to Intrastate AI
MERGR	Merger Compliance Expense Tracking. Costs incurred by various individuals and organizations participating in activities of merger core teams.	$39
SBCIL	Costs incurred in 1999 by the Network organization for work pertaining to the Illinois merger stipulations. Includes only AI and ASI costs.	28
UBREB	Costs incurred in 1999 by the Network and I/T organizations for activities associated with unbundled "rebundling". Includes only AI and ASI costs.	11
UBSTR	Costs incurred in 1999 by the Network and I/T organizations for activities associated with unbundled shared transport. Includes only AI and ASI costs	.6
2095	Costs incurred in 1999 by Ameritech Corporate (primarily Product Management) for work pertaining to the merger compliance activities.	6
	Total	$90

Source: Work Papers Supporting the "1999 Report of Recordation of All Savings and Costs for the Period Ending December 31, 1999" (Document Request DPV 1.8); Additional Information Regarding Charges to Merger Compliance Expense Tracking (Document Request ALA 10.1 and 10.4); Additional Information Regarding Charges to UBREB and UBSTR (Document Request EAL 10).

- As shown in Exhibit RCS-16 (provided previously), compliance-related costs comprised 2.9 percent of the AI's 1999 reported costs and 3.7 percent of the total negative net savings.

6. The 1999 Costs and Savings Report includes costs of $99,000 incurred prior to the October 8, 1999 merger date. We have estimated that $25,000 of these costs were allocated to AI. The inclusion of these costs in the 1999 Costs and Savings Report is not clearly supported by the Merger Order or Amended Order.

   - Exhibit RCS-20 provides a summary of pre-merger costs included in the 1999 Costs and Savings Report.

Exhibit RCS-20
Pre-Merger Costs Included in 1999 Costs and Savings Report

Tracking Code	Total Amount	Estimated AI Allocation (see Note)
SBCIL	$ 57,902	$ 17,485
UBREB	3,480	744
UBSTR	16,468	2,582
SBC98	17,420	3,485
SBC99	3,522	907
Total	$ 98,792	$ 25,203

Note: The $20,811 associated with tracking codes SBCIL, UBREB and UBSTR is included in the $90,000 compliance costs identified in Exhbit RCS-19. The amount of pre-merger costs excluding these compliance costs is $4,392.

Source: Support for Ameritech Illinois' Report for Recordation of All Savings and Costs For the Period Ending December 31, 1999 (Document Response DPV 1.8); BWG Analysis.

   - The Merger Order required Ameritech Illinois to track its share of all actual merger-related savings and all merger-related costs for the period *beginning on the date the merger is consummated* and ending on December 31, 1999.

   - The Company rationale for including these costs is that they were incurred for general compliance and other merger related integration activities. According to SBC, these costs were incurred to perform benchmarking activities and merger costs and savings tracking system set-up.

7. The 1999 Costs and Savings Report includes $2.7 million associated with the cost of conversion to a common SBC/Ameritech e-mail system as shown in Exhibit RCS-21. $0.5 million of this cost is allocated to the Illinois regulated jurisdiction. The inclusion of e-mail costs in the 1999 Costs and Savings Report is not clearly supported by the Merger Order or Amended Order since the Company has not specifically identified savings which are directly related to these costs.

Exhibit RCS-21
E-Mail Standardization
Net Cost Allocated To AI
(Dollars in Thousands)

USOA Account	Total Amount	AI Allocation
6124 Gen'l Purpose Computers	$1,385	$283
6623 Customer Services	883	167
6721 Accounting and Finance	178	38
6723 Human Resources	19	4
6724 Information Management	277	56
Total Cost Allocated to AI	$2,742	$548

Source: BWG Analysis; Work Papers Supporting the "1999 Report of Recordation of All Savings and Costs for the Period Ending December 31, 1999" (Document Response DPV 1.8).

- The Merger Order states that to "the extent that costs are incurred to produce savings and are shown to be both reasonable and *directly related,* we agree with the Joint Applicants that netting is appropriate." [Emphasis added]
- The Merger Recommendation Document for Team 99, Infrastructure, reports a "Run Rate Savings" for this conversion of *negative* $4.0 million.
- The Company states that "(d)irect savings from the costs associated with implementing MS Outlook cannot be measured and their nature cannot be defined discreetly." According to SBC, the savings associated with the common e-mail system is "tied to the merger initiatives of all teams."
- The Company also asserts that the e-mail conversion costs are not "transactional costs, but are service integration costs" directly tied to AI operations.

Allocation Factors

In determining the amount of cost or savings to be allocated to AI in the 1999 Costs and Savings Report, SBC applies allocation factors based on the corporate entity which originated the merger related costs or savings. This methodology is consistent with the Illinois cost allocation methodology described in the Merger Integration Team chapter.

- Savings or costs associated with Ameritech Illinois are allocated to AI at 100%.
- Ameritech Services Inc. costs and savings are allocated to AI by applying the weighted Ameritech allocation factor for AI of 31.88%
- Costs and savings related to SBC and Ameritech Corporate organizations are allocated to AI utilizing SBC Parent factors specific to AI.

Exhibit RCS–22 (page following) summarizes the allocation factors utilized for each category of cost and savings:

Exhibit RCS-22
Ameritech Illinois 1999 Merger Costs and Savings Allocation Factors
(Dollars in Thousands)

Tracking Code or Category	Description	Savings				Costs			
		Illinois Bell	ASI	AIT	SBC	Illinois Bell	ASI	AIT	SBC
Severance	Severance costs and savings.	100%	31.88%			100%	31.88%		
AIT Savings	AIT severance savings.			3.45% 6.86% 8.95%					
SBCCT	IT's participation in merger core teams.						31.88%		
SBDSL	IT's participation in merger core teams.						31.88%		
MERGR	Costs incurred by various individuals and organizations' participation in merger core teams.					100%	31.88%		
SBCIL	Illinois merger stipulations.					100%	31.88%		
UBREB	Unbundled "rebundling."					100%	31.88%		
UBSTR	Unbundled shared transport.					100%	31.88%		
2095	Merger compliance.							3.45% 8.95%	
Vacancies	Vacant positions.	100%	31.88%	3.45% 6.86%	3.45% 6.86%				
Implementation	Relocation costs, e-mail and licensing costs of personal computer tracking software.						31.88%	3.45%	3.45% 8.95%
SBC01	Participation in merger core teams.					100%	31.88%		
SBCST	IT's participation in merger core teams.					100%	31.88%		
SBC98	IT benchmarking.						31.88%		
SBC99	IT benchmarking.					100%	31.88%		
Non-Wage Savings	Procurement and insurance.		31.88%	19.24%	6.86%				

Note: 100% represents a direct allocation to AI; 31.88% is the five state allocation factor specific to ASI; 3.45%, 6.86% and 8.95% are SBC parent allocation factors specific to AI; 19.24% is an Ameritech Corporate allocation factor specific to the insurance costs included in Account 6728-General and Administrative. Areas shaded in gray had either no reported costs or no reported savings in 1999. A blank space indicates no costs/savings were included for that specific entity in the 1999 Costs and Savings Report.

Source: BWG Analysis; Support for Ameritech Illinois' Report for Recordation of All Savings and Costs For the Period Ending December 31, 1999 (Document Request DPV 1.8).

8. While the Company used appropriate methodologies to allocate costs and savings incurred by other entities to AI, accounting cut-offs and timing differences resulted in a number of mismatches of cost and savings.

   - $2.3 million of 1999 AIT Parent severance savings were included in the 1999 Report while the associated $25.6 million of severance costs were not. The Company has indicated that these costs will be considered for inclusion in the Year 2000 Report.

   - While the 1999 Cost and Savings Report includes the 1999 savings associated with SBC vacancies, it includes neither the costs nor the savings associated with SBC severances in 1999.

   - Combining the Year 1999 Report and Year 2000 Report would provide a better matching of costs and savings.

9. The SBC Parent Allocation factors were appropriately applied. Revised allocation factors will be calculated for the year 2000 and should be reviewed to determine their consistency with the 1999 factors.

   - The factors were developed in accordance with the SBC Parent Cost Allocation System reference guide. The factors developed by the Company which were used in the 1999 Costs and Savings Report are:

     ⇒ Investment Factor: designed to match the cost of generating or maintaining invested funds with the benefits derived from these funds.

     ⇒ Force Factor: designed to match the cost of services provided to the subsidiaries based on their employee base with the benefits received.

     ⇒ General Factor: assigns costs of work performed for all subsidiaries for which direct charge or other allocation factor is not appropriate.

   - In preparing the 1999 Cost and Savings Report, the Company matched the above factors with the appropriate USOA Account for allocation of the costs and savings to AI.

   - At the time of this report, year 2000 SBC Parent allocation factors were not available for comparison with those used in the 1999 Costs and Savings Report. Since the year 2000 factors will be based on a full year of post merger historical information they should be compared with those applied in the 1999 Report to identify any significant deviations.

Merger Transaction Costs

10. Although the Merger Investigation RFP requires a review of merger transaction costs, the Company is not required to separately report such costs to the Commission. The

Commission has only required that these costs not be netted against merger savings or otherwise recovered from ratepayers.

- The Amended Order clarified that "Ameritech Illinois is required to track its share of all actual merger-related savings and all merger-related costs.... As noted earlier, merger-related costs shall not include 'transactional costs.'"

- The Commission defined savings as a reduction in costs or expenses, and excluding revenue enhancements. The Commission defined costs to exclude one-time merger transaction costs which relate to the change in ownership of Ameritech, and agreed with the Staff's position to allow recovery of only those costs directly associated with the utility's operations.

11. SBC has identified about $156.0 million in 1998 and 1999 one-time merger costs that were appropriately classified as merger related transaction costs. However, the $156.0 million may not represent the total transaction costs since the Company is not required to separately report such costs.

    - As shown in Exhibit RCS-27 (page following), 70 percent of the $156.0 million merger-related transaction costs are banker and legal fees, which is consistent with the definition of transaction costs outlined by the Commission in its Amended Order.

    - Merger transaction costs were not allocated to Ameritech Illinois or any other SBC affiliate in 1998 or 1999. Costs included in the $156.0 million will be billed in 2000, but will not be included in the net savings calculations. They are currently being held until appropriate allocation factors can be developed.

12. In addition to the $156.0 million of merger transaction costs identified by the Company, the Company has also incurred $21.9 million in Executive Committee Change in Control and retention payments that are being tracked independently from the $156.0 million, but are considered "below-the-line" and will not be charged to AI regulated operations.

    - Executive Committee Change in Control severance payments totaled (redacted) in 1999, and SBC will pay out an additional (redacted) in 2000, for a total of (redacted). Portions of these costs are summarized by employee classification in Exhibit RCS-4 and by position title in Exhibits RCS-5 and RCS-8. They are recapped in Exhibit RCS-28 (page following) in the aggregate to summarize the costs the Company has identified for exclusion in the net savings calculations.

Exhibit RCS-27
Summary of 1998 and 1999 Transaction Costs
(Dollars in Thousands)

Category	SBC	AIT	Total	Percent	Examples
Bankers Fees	$33,000	$31,169	$64,169	41	Financial advisory and investment banking services
Legal Services	22,931	22,325	45,255	29	Outside counsel, securing regulatory approval, economists
SEC Fees	7,566	14,512	14,512	9	Filing fees
Shareowner Services	9,719	3,151	12,870	8	Ameritech Exchange, accrual of share exchange expense, printing notice/proxy statement, processing positions
Other Consulting	2,375	3,887	6,262	4	Economic consulting, legal support, political consulting
PR and Advertising	5,348	419	5,767	4	Employee Merger Announcements
Accounting Services	1,714	999	2,713	2	Balance sheet review of Ameritech accounting polices and practices, audit of accounting adjustments
Contributions	1,419		1,419	1	Citizenship Education Fund, Rainbow PUSH Coalition, Digital Freedom Institute and others
Insurance	1,174		1,174	1	Directors and Officers, fiduciary liability
Other	635	221	856	1	Depreciation, mail services, meals, copier rental, office supplies, phone, printing
Wages	448	75	523	<1	
Travel	218		218	<1	Airfare, hotel, taxi, parking
Temporary Labor	164	53	217	<1	
Total	$86,711	$69,244	$155,954	100%	

Note: These costs do not include Executive Committee Change in Control payments or retention bonuses.

Source: Transaction Cost Detail (Document Requests ALA 2 and ALA 5.5).

Exhibit RCS-28
Summary of Executive Committee Merger Costs
(Dollars in Thousands)

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13. With the exception of employee-related costs, SBC's treatment of one-time merger transaction costs is consistent with the requirements of the Amended Order, as shown in Exhibit RCS-29. Employee-related costs were discussed previously.

Exhibit RCS-29
Commission Identified Cost Categories Included in Merger Transaction Costs

Category (as identified in the Amended Order)	**Included in $156M of Transaction Costs?**	**Costs Incurred in 1999?**	**Included as offset to 1999 savings?**	**Explanation**
Included in $156 M of identified merger transaction costs				
Fees and expenses of financial advisors and consultants and lawyers	Yes			
Filing fees	Yes			
Proxy costs	Yes			
Costs of securing regulatory approval of the transaction	Yes			
Treated as "below-the-line" and excluded from $156 M of merger transaction costs				
Employee retention payments	No	Yes	No	The only costs incurred in 1999 were the $2.5 million payment to the CEO. These costs are being tracked separately. No costs were included in the Regulated Intrastate Jurisdiction for 1999.
Executive Committee change in control payments	No	Yes	No	These costs are being tracked separately. No costs were included in the Regulated Intrastate Jurisdiction.
Not treated as transaction costs, and were included as an offset to savings				
Employee severance costs	No	Yes	Yes	The Company does not consider these costs to be one-time transaction costs.
Employee relocation costs	No	Yes	Yes	The Company does not consider these costs to be one-time transaction costs.
Not included in $156 M of identified merger transaction costs as no costs were incurred				
Costs of third party auditing or technical assistance necessary to comply with conditions imposed by the Commission in the order	No	No		No costs were incurred in 1998 or 1999. Future costs would be considered merger transaction costs.
Administrative costs associated with the CEF	No	No		There are no administrative costs associated with the CEF.
Payments to the CEF and CTF.	No	No		Future costs would be considered merger transaction costs.
Costs of penalties should conditions and benchmarks imposed by the Commission in this Order not be met	No	No		No costs were incurred in 1998 or 1999. Future costs would be considered merger transaction costs.

Source: BWG Analysis; Amended Order pp. 7 and 10; Transaction Cost Detail (Document Requests ALA 2); Verification Request ALA 7; and follow-up with Director of Regulatory/State Financial Issues (AI).

- Fees and expenses of financial advisors, consultants and lawyers; filing fees; proxy costs; and the costs of securing regulatory approval were appropriately included in the $156.0 million of merger transaction costs identified by the Company. These costs were not included in the 1999 merger implementation costs reported to the ICC, and according to the Company will not be included in the Illinois regulated jurisdiction.

- Costs associated with the CEF and CTF, costs of third party auditing, and the costs of penalties should Commission conditions and benchmarks not be met were not incurred in 1999. Future costs would be considered merger transaction costs.

- Executive Committee Change in Control payments and retention bonuses are being tracked separately from the $156.0 million in merger transaction costs, but were not included in the 1999 merger implementation costs reported to the ICC, and according to the Company, will not be included in the Illinois regulated jurisdiction.

- The Company does not consider all employee severance and relocation costs to be transaction costs. Portions of these costs were included in the 1999 merger implementation costs reported to the ICC as an offset to merger savings.

14. As a result of the merger with SBC, substantially all stock options granted prior to May 11, 1998 pursuant to Ameritech Compensation and Benefit Plans became fully vested. Although there are no accounting costs to be recognized relating to this transaction, there may be significant economic costs.

    - At the date of the merger, Ameritech had approximately 44 million optioned shares outstanding of which approximately 25 million shares were exercisable. The options have a maximum life of ten years and one day and become exercisable after one year from the date of grant in equal increments over the following three years.

    - Under Change in Control Agreements in effect at the date of the merger, approximately 19 million shares became immediately exercisable. The aggregate difference between the option price and stock closing price at the date of the merger of these 19 million shares was $419 million.

    - Under Statement of Financial Accounting Standards No. 123 (FAS 123), *Accounting for Stock-Based Compensation*, issued by the Financial Accounting Standards Board (FASB) in 1995, the value of stock options at the date of grant must be calculated using an option pricing model. Like most companies, Ameritech elected the "pro forma, disclosure only" option permitted by FAS 123 and recorded no compensation expense relating to the options.

    - However, with the immediate vesting of the options, the intended compensation value changed because of the failure of the original assumptions in the pricing model relating to market risk, the time frame for vesting, and potential forfeiture. This increases the benefit of the options to the recipient, and has an economic cost to the Company.

- The early vesting of stock options raises several economic issues, including

  ⇒ What is the difference in the compensation value of the options calculated using actual information in the pricing model rather than the original assumptions?

  ⇒ To the extent options are exercised, what is the impact of the additional shares on the Company's capital structure and what assumptions should be made regarding the use of proceeds?

  ⇒ How will the changed economics be perceived by the Commission?

Severance Quantification

15. Preliminary MIT estimates indicate future severance and relocation costs may exceed $300 million as shown in Exhibit RCS-30. If SBC follows the same procedure it used in 1999, a portion of these costs will be allocated to Illinois.

Exhibit RCS-30
Estimated Merger Severance and Relocation Costs
(Dollars in Thousands)

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16. Tier B and below management employees received higher severance benefits under the change in control agreement than was available to them without a change in control.

    - As required by the audit contract, BWG quantified the difference between the change in control severance payments actually made and those which would have been made had the same individuals terminated their employment and received severance benefits absent a change in control.

Exhibit RCS-31
Comparison of Severance Benefits - Tier B and Below Management Employees
(Dollars in Thousands)

Entity	1999 Change in Control Payments	Estimated Payments Absent Change in Control	Difference (Actual -Estimate Absent Change in Control)
Ameritech Illinois	$509	$78	$431
ASI	1,040	160	880
Total	$1,549	$239	$1,310

Note: Estimated payments absent change-in-control do not include tuition repayment and the six months of paid benefits to which individuals are entitled under the Management Separation Benefit Plan. Assuming a benefits rate of 25 percent, this would add approximately $60,000 to the estimated payments absent change-in-control.

Source: BWG Analysis, Support for 1999 Reported Costs and Savings (DR DPV 1.8), 1999 Reported Costs and Savings Severance Payments by Individual (DR ALA 8), Salary and Employment Information (DR ALA 23.3), "Ameritech Termination/Severance Report as of 04/07/2000" (DR JDH 3.3).

17. A precise quantification of severance benefits that CRSPP-eligible employees would have been paid absent a change in control cannot be made for the following reasons.

    - Absent a change in control, severance benefits for CRSPP-eligible employees were paid on a negotiated basis or based on individual employment agreements.
    - The Company does not document the reasons for the separation of employees in salary grades CR1 through CR9. Exhibit RCS-32 provides the severance benefits paid to the last 14 individuals who left the Company in the 12 months immediately prior to the merger; however, as a result of the absence of documentation, we are unable to determine whether these employees retired, resigned or were terminated.

Exhibit RCS-32
Comparison of Severance Benefits - Corporate Resource Severance Pay Plan
(Dollars in Thousands)

Benefit Paid	Number of Employees Receiving Benefit Level
24 months base salary. Company paid health, dental, vision coverage for 6 months. Outplacement counseling for one year plus maximum of $5,000 for educational assistance.	2
12 months base salary plus target bonus. Company paid health, dental and vision coverage for 12 months plus outplacement counseling for one year.	1
6 months base salary. Outplacement counseling for one year plus maximum of $5,000 for educational assistance.	3
No benefit paid	8
Total	14

Note: Amounts shown do not include cost of benefits, outplacement counseling or educational assistance. Ameritech does not maintain records regarding the reasons for departure when executive level employees leave Ameritech. The executives listed above may have retired, resigned or have been terminated.

Source: BWG Analysis, Support for 1999 Reported Costs and Savings (DPV 1.8), 1999 Reported Costs and Savings Severance Payments by Individual (ALA 8), "Ameritech Merger Related Terminations CRSPP = Corporate Resource Severance Pay Plan" (JDH 3.2), Severance packages offered to the last 14 CRSPP eligible employees to leave Ameritech (ALA 24.1).

Quantified Results of Investigation

1. SBC has appropriately excluded $177.8 million of costs incurred in 1998 and 1999 ($156.0 million of transaction costs and $21.9 million of severance costs) from its consideration of recoverable merger-related costs. As required by the Merger Order, these costs were not reported to the Commission in the 1999 Cost and Savings Report.

Exhibit RCS-34
Costs Appropriately Excluded From Reported Costs and Savings
(Dollars in Thousands)

Cost Category	Amount	Treatment
Company Identified Merger Transaction Costs	$155,954	Categorized as one-time merger transaction costs
Executive Committee Payments	12,100	Separately tracked, but also excluded
Executive Committee Services and Non-Compete Agreement Payments	7,274	Separately tracked, but also excluded
CEO Retention Bonus	2,500	Separately tracked, but also excluded
Total Excluded	$177,828	

2. The quantification of questioned costs and savings included in the 1999 Cost and Savings Report results in an adjusted net savings total of $0.1 million for AI in 1999.

   - As discussed in Findings No. 4 through No. 7, there are $1.3 million in questioned costs due to the possibility that the Company's regulatory interpretation may differ from that of the Commission. A summary of these questioned costs is provided below.

Exhibit RCS-35
1999 Questioned Costs
(Dollars in Thousands)

Category	Amount Allocated to AI	Reason Questioned
Severance Costs	$651	Possible Transaction Cost
Relocation Costs	19	Possible Transaction Cost
Compliance Costs	90	Possible Transaction Cost
Pre-Merger Costs	4	Incurred pre-merger
E-mail Costs	548	Not tied to future savings
Total	$1,312	

Note: The pre-merger costs identified in this audit include $21,000 of compliance costs. To avoid double counting, only $4,000 pre-merger costs are listed in this Exhibit.

   - The quantification of questioned costs and savings identified in this report results in an adjusted net savings total of $0.1 million for AI in 1999 as shown in Exhibit RCS-37.

Exhibit RCS-37
Quantification of Questioned Costs And Savings
Included in the 1999 Costs and Savings Report
(Dollars in Thousands)

Description	Merger Savings	Integration Cost	Net Savings (Costs)	Reference Conclusion
1999 Costs and Savings Report Total	$351	$1,571	$(1,220)	
Questioned Costs				
Severance Costs		(651)	651	4
Relocation Costs		(19)	19	4
Compliance Costs		(90)	90	5
Pre-Merger Costs		(4)	25	6
E-mail Costs		(548)	548	7
Subtotal		(1,312)	1,312	
Adjusted 1999 Costs and Savings Report Totals	$351	$259	$92	

Recommendations for the Company

1. Submit a revised 1999 Cost and Savings Report to the Commission incorporating the agreed-upon adjustments identified in this report. Explain reasons for disagreement with any of the adjustments proposed. Alternatively, to correct the cut-off problems noted as of December 31, 1999, request permission from the Commission to combine 1999 cost and savings information with year 2000 information in the Year 2000 Report. In this way, the Year 2000 Report will include costs and savings information in the for the year and 84 day period from the date of the merger (October 8, 1999) through December 31, 2000. (Refers to Conclusions No. 2, 4, 5, 6 and 7)

Policy Issues for the Commission

None

Future Audit Issues

2. Obtain merger costs and savings information at a level of detail greater than that which is available from AI by USOA account. Reference to the Company's tracking codes is needed for a complete understanding of the nature of specific costs and savings. (Refers to Conclusion No. 1).

3. Unless the Company re-files 1999 Cost and Savings Information in combination with information provided in the Year 2000 Report, perform extensive cut-off tests as of December 31, 1999 to ensure that there is an appropriate matching of costs and savings and that costs are not double counted. (Refers to Conclusion No. 2)